

**CANADIAN CORPORATE GOVERNANCE
POLICY OPTIONS**

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1. GLOBALIZATION: THE ECONOMICS BEHIND THE SCENES

No crystal ball is required to predict that, in the coming decades, the Canadian economy will increasingly be subjected to the phenomenon the popular press has labelled “globalization”. Some key effects of globalization on Canada are already evident. One of them is that consumers now have greater choice because products from all over the world are available in Canada at affordable prices. Another is that globalization constrains government in new ways. Investors, entrepreneurs and businesses who do not like Canadian government policy are free, as never before, to take their business elsewhere. Globalization has also opened world markets to Canadian businesses while at the same time subjecting many Canadian companies to competition from parts of the world almost unheard of a decade ago. In Canada, the combined effects of globalization have forced a rapid rationalization of the economy, which has disrupted the *status quo*. People of different ideological persuasions may view these effects in different lights, but there is no longer any doubt that the effects are real.

The purpose of this paper is to examine corporate decision-making in Canada and to clarify the factors that, in the past, have sometimes led to less than optimal corporate governance. In this context, poor corporate governance practices that might have been tolerable even recently are now untenable. Our ultimate goal is to clarify government policy options that are realistic in the new global economic environment and also likely to improve Canadian corporate governance.

In 1930 the Austrian economist, Joseph Schumpeter, proposed that a process he termed “creative destruction” underlies the success of capitalism. Capitalism hugely, some would say obscenely, rewards people who *create* innovations that improve efficiency or better meet consumer demand. Capitalism also destroys firms, sometimes brutally, that fail in these dimensions. Creative destruction, Schumpeter argues, leads to unmatched improvements in both production efficiency and living standards. Increasingly, mainstream economists are accepting Schumpeter’s ideas, and now widely agree that giving free reign to capitalist creativity is more important than avoiding transitory monopoly pricing or other economic distortions.

Over the last several decades, the role of markets has increased steadily in both the industrialized and developing world. In large part, this growth of market importance, and the consequent premium on competitiveness, is related to the global integration of product, capital, and labour markets. The source of this integration has been thoroughly canvassed elsewhere and is mainly the result of reductions in domestic trade-protection barriers, technological innovation, and the liberalization of the command-based economies. The premium on international competitiveness has been felt more acutely in Canada than in other countries, owing to this country’s relative openness to foreign competition. Compared to other OECD countries, the Canadian economy exhibits high levels of export dependency and import penetration. Canada’s export sector, for instance, constitutes 25.2 percent of the domestic economy — second only to Germany’s among the G7 countries in terms of the importance of export trade to the overall economy.¹ Likewise, in 1970 Canada’s import penetration rate was more than five times that of the United States, and was three times the U.S. rate in 1985.² Another indication of Canada’s dependence on external markets is the high level of foreign direct investment. In 1990 for instance, Canada received 5 percent of the total foreign direct

investment inflows to larger industrialized countries, whereas the United States, with an economy roughly 10 times as large, received only 29 percent.³

The increasing openness of industrialized economies to the pressures of external markets has spawned a number of different effects. One of the most important is a sharp increase in the pace of innovation. In 1992, 187,200 patent applications were filed in the United States, up from 105,300 in 1972 and 68,384 in 1952. There were also 3,107 new product introductions in the United States in 1992, up from 1,762 in 1982.⁴ When less tangible innovations are included in areas such as human resources management, marketing strategy, etc., the rate of creativity may well be even greater. Continual innovation is expensive, so innovative firms need to be able to reach large numbers of customers quickly in order to earn maximum returns on their creativity. Access to global markets is therefore essential for Canada, and that means granting foreign firms reciprocal access to Canadian markets.

This stepped-up pace of innovation means firms that lag behind can be pushed into obsolescence, and their work forces left high and dry. An innovative new competitor from a remote corner of the world can grab market share with little warning. The bankruptcy rate tracks the downside of this creativity explosion. In 1993 in the United States, 85,982 businesses failed; in 1952 there were 8,862 business failures.⁵ Of course, bankruptcy laws and practices have changed over the years, as has the distribution of company failures across industries. Also, the employees of failed companies do not always lose their jobs. Often in bankruptcy, the creditors sell off the assets of the defunct firm as a unit and the buyer retains many or most of the predecessor firm's employees. Nonetheless, this increased pace of bankruptcy has substantial social costs.

In Canada there appears to be a clear national interest in fostering innovation, in encouraging Canadian firms to get ahead and stay ahead, and in cushioning firms that fall behind. Yet, the globalization of the economy constrains government in new ways too.

Traditional government policies based on taxes and subsidies are in disrepute. Government subsidies and tax credits for R&D are perhaps more likely to foster innovative "mining" of the government than true innovation. Government industrial policies that have sought to pick winners and subsidize their growth have seldom succeeded. Even the one previously notable exception, Japan, is now known to be no exception at all. Beason & Weinstein (1994) collected hard data on how much money the Japanese industrial policy directed at whom; and show convincingly that subsidies in that country were directed mainly at losers. The recipients of the biggest subsidies in Japan were weak firms whose collective performance actually declined subsequently. Indeed, taxing winners to subsidize losers, or even potential winners, is particularly unwise in a global economy where individual nations must compete for mobile capital and, especially, for information (i.e., people with expertise). Both capital and people can go elsewhere if they are too heavily taxed. In this new environment, taxing winners heavily to cushion losers is likely to lead in short order to a country of losers.

In short, government itself has become a competitive business in the new global economy. In the past, governments were monopolies. Businesses and people who did not like the government

of the day could work to change it, but rarely could they simply take their business elsewhere. Today they can, and do. Governments are therefore under pressure themselves to become “competitive”. Competitive government is not necessarily small government; rather, it is government that provides services most people and businesses want at tax rates they are willing to pay. Understandably, selective subsidies financed by taxes levied on everyone are seldom seen to fit these categories.

How then is government, robbed of its traditional policy tools, to promote the public interest in this new economic reality? We devote the final study in this volume to a list of viable options. A central thrust of our analysis is that governments should focus on *framework policy*. That is to say, the state should focus on providing the legal and institutional environment in which markets and firms are able to thrive. As Michael Porter has observed⁶

...[g]overnment’s proper role is as a *pusher and challenger*. There is a vital role for pressure even adversity in the process of creating national competitive advantage .. . Sound government policy seeks to provide the tools necessary to compete, through active efforts to bolster factor creation, while ensuring a certain discomfort and strong competitive pressure.

In our view, a core feature of an effective framework for competition is the nature and quality of the corporate governance system that obtains in a given country. Here, we refer to the legal and market institutions that make up a country’s corporate governance system. Nevertheless, before we begin to think about the precise nature of an optimal corporate governance system, there is great need to sort out where exactly the public interest lies in issues of corporate governance.

2. CORPORATE GOVERNANCE AND THE PUBLIC INTEREST

The standard of living enjoyed by Canadians depends critically on the success of Canadian business, which in turn depends on the decisions made by its top managers. Those decisions are heavily influenced by the legal and institutional settings in which directors and corporate officers function. How should corporations be run? If we are to propose ways in which government might improve their management, we must consider how corporate decision-making can go awry in the first place. This depends critically on the nature of the firm in question.

Why Care About Maximizing Shareholder Value?

A corporation is a legal fiction. It has the rights and responsibilities of a “legal person”, yet it is owned by shareholders, and has complex contractual links to its employees, creditors, customers, suppliers and the community – collectively termed its “stakeholders”. Often, the interests of a firm’s shareholders and various stakeholders conflict with each other and with others’ perceptions of the greater good. This begs the question of whose interests should be paramount?

It is conventional wisdom, as well as orthodox economic theory, that those who bear the costs should have the decision-making authority. Theoretically, at least, this avoids problems analogous to out-of-control medical bills that arise from authorizing physicians to order tests and obliging taxpayers to pay for them.

A normal, healthy corporation has well-defined, legally enforceable contractual commitments to its employees, creditors, customers, suppliers and community. It may not, in the normal course of business, default on wages, interest payments, promised shipments, promised payments, or taxes. However, the shareholders have no such contractual rights. Rather, they are residual claimants. Whatever money the firm has left over after paying off its contractual obligations can either be paid out to shareholders as dividends or reinvested to generate capital gains for shareholders. The firm can freely alter its dividend payments and investment policies with few legal consequences. Thus, when unwise business decisions are made in the boardroom, it is the shareholders who pay the price. For this reason, economic theory dictates, corporations should be controlled by their shareholders.

Economic theory, as with any theory, is a simplification of reality. When a firm does poorly, employees may be laid off without the firm actually going bankrupt. Some stakeholders may thus bear more of the costs of bad management than will the typical shareholder. But most stakeholders do not. Senior workers are usually well protected from layoffs. Of course, if a corporation is run extremely badly, it may default on its wages, interest payments, deliveries and bill payments too. But this will happen only when shareholder value sinks to zero and the firm is bankrupt. Under such circumstances, bankruptcy trustees must run the firm in the interests of the creditors and other former contractual claimants who have been made residual claimants. In any event, from a policy perspective it is important to focus on those stakeholders who suffer from certain contracting disabilities, and are thus unlikely to have been able to anticipate and so negotiate for effective protection from the firm (in the form of *ex ante* compensation or *ex post* severance benefits) against the risks of dislocation.

For these stakeholders, strong policy arguments exist for some type of public intervention, although not through modifications to the traditional apparatus of corporate governance.⁷

Ultimately, the reason good corporate governance is important is that its absence would erode public confidence in Canada's financial markets and therefore depress share prices. Such a lack of confidence would make raising equity capital very difficult for Canadian companies, limiting their potential for growth. This, in turn, would slow economic growth and thus exacerbate problems such as unemployment and government deficits. Good corporate governance, therefore, is unquestionably in the public interest.

Directors are Shareholders' Representatives

In practice, in firms with many shareholders, it is difficult for all shareholders to be consulted on all business decisions. The solution is the board of directors. Directors are elected by the shareholders and paid to represent the interests of the shareholders in corporate decision-making. To emphasize the ultimate purpose of the board, the law makes directors personally liable to lawsuits by shareholders if they fail in this duty. Officers of the corporation, top managers such as the CEO, president and senior vice-presidents, are assigned a similar legal duty and liability. In the jargon of economics, this is a type of *principal-agent relationship*: the shareholders are the *principals* and the officers and directors are their *agents*. Corporate directors and officers are required to act in the best interests of the corporation, and that means the best interests of its legal owners — the shareholders.

Shareholders and Stakeholders: A Practical Compromise

To some, this doctrine may seem to be excessively narrow. There are, after all, others besides shareholders whose fates are interwoven with that of the firm: its employees, creditors, managers, customers, suppliers, and the communities that depend on it. To reiterate, these parties are the firm's *stakeholders*.⁸ Would it not be better if top managers ran the firm in the best interests of society, or the community, or at a bare minimum the workers and the shareholders together?

The economist's response is based on two considerations. First, the legal system collapses all of these into the interests of shareholders alone. If a firm passes over top (well-qualified) job applicants because of racial or gender prejudice, firm performance is suboptimal and the shareholders lose. If a firm pollutes the environment and is sued, the shareholders lose. If it mistreats its workers and is subjected to strikes or other labour unrest, share prices and dividends fall and, again, the shareholders lose. Second, even when managers make patently foolish decisions, they can usually point to some resulting social good — for example, benefits to some group of workers. Clearly, assigning a manager such a multi-dimensional responsibility effectively erases all responsibility. In this context, responsibility to all means responsibility to none. The law has evolved a workable compromise. Managers owe principal duties to shareholders, but the legislatures and the courts have developed a range of overriding duties (and corresponding sanctions) to ensure fidelity to broader social goals. As a consequence, a corporation cannot claim devotion to shareholder interests to justify its neglect of explicit occupational health and safety, environmental, or human rights obligations. Not only will a failure by the corporation's agents to meet those obligations subject them to individual

sanctions, the law also imposes financial sanctions on the firm's shareholders in the form of penalties levied on the corporation. In this way, shareholders have powerful incentives to monitor and discipline corporate misconduct. This compromise has strong efficiency properties; but it is also overlaid with a thick layer of democratic theory. Instead of vesting an unelected and unrepresentative cadre of senior corporate managers with the task of determining how corporate resources should serve the public good, this model relies on accountable and elected legislatures to make those decisions. This means that the decisions as to when and how corporate externalities should be internalized are fully transparent and subject to full and proper public deliberation and accountability.

Myopia

Another widely repeated concern with focusing on shareholders' interests is that shareholders themselves are said to be myopic. It is alleged that they are concerned mainly with short-term performance, so excessive catering to the wishes of shareholders means forsaking long-term investments. As the study by Giammarino (1995) explains very convincingly, there is absolutely no credible evidence that this concern has any basis in fact. Statistical analyses of large numbers of U.S. firms show that firms' share prices rise when they announce long-term investment projects or large R&D programs. The apparent conclusion is that long-term investments please shareholders. This is supported by other studies that find a strong and sustained positive correlation between R&D spending and share value. If firms do have a short-term bias, there is strong evidence to suggest that the average shareholder would be pleased to see this change.

Principal-Agent Duties

A more legitimate concern is that under some conditions managers can ignore small, poorly informed shareholders. Thus, a board with a single large active shareholder may toady to that shareholder while small investors, who collectively own most of the firm, are effectively disenfranchised. In firms that do not have a large shareholder, such as the large chartered banks, there is a danger that managers may ignore shareholders entirely and run their firms as personal fiefdoms. Shareholder rights activists allege that managers can then pursue pet projects, adopt biased hiring policies, and otherwise waste the shareholders' money. Such breakdowns of the principal-agent relationship are termed *agency problems*. Mainstream economics recognizes that various sorts of agency problems are pervasive throughout both the public and private sectors. Indeed, some economists even go so far as to allege that agency problems are the chief cause of economic inefficiency in modern capitalist economies.

Although agency-cost nomenclature is relatively new, the concept of accountability which underlies it is not. Since the early part of the century, corporate scholars have worried about the accountability problems set in train by the delegation(s) of authority required to realize gains from specialization in the modern corporation. Berle & Means' (1932) seminal study of the American corporation was focused precisely on this issue. It was these scholars who coined the phrase "separation of ownership and control" to describe the American system of corporate governance. Berle & Means conceived corporate America as riven by pervasive accountability problems emanating

from scattered, small-stakes shareholdings. With so many shareholders, there was no incentive on the part of any shareholder to assume responsibility for controlling the affairs of the corporation. The consequence was virtually unchecked power for American corporate managers and the resultant suppression of the profit motivation.

In retrospect, it is clear that the Berle & Means' account was overly bleak. While it is undoubtedly true that small-stakes shareholders exert very little, if any, direct control over directors and managers in large public corporations, it does not necessarily follow that managers are entirely unbridled and free to frolic on their own. As a number of law and economics scholars have demonstrated, a variety of legal and market devices work to align managerial and shareholder interests. Legal instruments (such as shareholders' rights to sue directors and officers) ensure managerial accountability by imposing *ex post* costs on self-dealing managers. Market instruments (such as the takeover or the "corporate control" market, the market for managers, and the capital market) typically focus on less malign sources of managerial misconduct, and operate either directly (through the threat of displacement or debased reputation) or indirectly (through provision of information on managerial misconduct to parties capable of taking direct action). The existence of these various legal and market instruments does not mean, however, that the problem of accountability is trivial in the modern corporation; some residual agency problems remain. Rather, the claim is that the legal and market arrangements that comprise the system of corporate governance are fairly robust and, thus, to the extent that improvements to that system can be made through institutional reconfiguration, these gains are on the margin.

The Role for Law

If firms are based on voluntary activity among well-informed deliberative stakeholders, and if markets play an important supporting role in disciplining managerial misconduct, what role is there for law and legal institutions? As mentioned earlier, if it can be demonstrated that certain stakeholders are being denied access to adequate information, that their bargaining with the corporation is beset by severe asymmetries in power, or that they are being coerced into certain commitments with the corporation, then a plausible case for some sort of government intervention can probably be made. Nonetheless, most commentators agree that, save for employees, claims of this sort are unpersuasive; and even in those cases where the claims are clearly legitimate, it is not altogether clear that the best form of state intervention is through corporate law—because corporate law is usually viewed as being devoted to shareholder and, to a lesser extent, creditor interests. Policy makers must therefore be very careful about overloading a single regulatory instrument with multiple and often conflicting goals. This would be the result if the interests of employees and other constituencies deserving of protection were to be protected through corporate law.

If corporate law is, indeed, primarily about shareholder interests, what form should it take? Early corporate statutes contained several mandatory elements that were clearly in support of a highly interventionist role for the state in ordering private arrangements. Today, however, the clear trend in corporate law is toward an enabling regime, which confers considerable latitude on parties to pick and choose among various background terms. This enabling role for corporate law is consistent with the belief that the interaction between a shareholder and the corporation is largely voluntary in nature,

and the law should, as much as possible, defer to the wishes of contracting parties. Viewed in these terms, the role for corporate law is clear: lawmakers should develop and maintain a corporate law regime that facilitates contracting by private parties. One way to accomplish this is to supply background legal terms that economize on the costs of repeated negotiation for private parties. Another way to facilitate private contracts is through the supply of certain terms that private parties are unable to generate on their own because of high investment costs and risks of appropriation (the public goods problem). The elaborate system of fiduciary duties developed under corporate law is an example of such a public good.

3. CORPORATE GOVERNANCE PROBLEMS IN CANADA

The economics underlying these agency problems varies across types of firms. We examine each of the most common types of corporation in turn.

Widely Held Firms: Other People's Money?

A firm is widely held when it is owned by a large number of small shareholders, each of whom has no effective control over management decisions. Some of Canada's largest firms, and almost all large U.S. firms, fall into this category. All the major Canadian chartered banks are widely held. So are Bell Canada and Air Canada. Although these and a number of other prominent Canadian firms are widely held, this genre of ownership structure is not common in Canada. Morck & Stangeland (1994) place only 16 percent of the 550 largest Canadian corporations in this category in 1989.

It is commonly alleged that in widely held firms managers too easily forget their duties as shareholders' agents and govern their firms to benefit themselves. This agency problem impoverishes shareholders and undermines the economic logic that links optimal corporate policy to the common good. For example, suppose a manager gains status and social influence from an unprofitable film-making subsidiary. Closing it would benefit the firm by \$5,000,000 but would cost him (personally) intangible losses he values at \$50,000. If he owns one-half of one percent of the firm's outstanding shares (a situation not uncommon in many large widely-held firms) he will forego \$25,000 of share value but keep \$50,000 in intangible benefits. He thus comes out \$25,000 ahead. The other shareholders lose the remaining \$4,975,000, perhaps without ever knowing they might have had it. Private admissions by corporate insiders, as retold by Mace (1971) reveal such instances to be disturbingly common in large U.S. firms. We doubt that large Canadian firms are entirely innocent either.

Of course, most self-serving behaviour by managers is less transparent. It might involve a phenomenon economists have dubbed "managerialism": corporate empire building through unprofitable takeover binges that enhance only the top managers' egos. Another possibility is ethnicity or gender-biased hiring or promotion policies that keep things comfortable for the managers but cost shareholders the value the best candidates would have added to the firm. Yet another example of managers' self-serving behaviour is funnelling shareholders' money into economically questionable pet projects such as unviable subsidiaries in exotic places. Some managers actually find it so wrenching to pay out cash windfalls to shareholders through increased or extraordinary dividends that they invest in almost any project, no matter how unprofitable, to keep the money inside the firm and under their control. Unnecessary Lear jets and palatial head office buildings are almost a caricature of self-serving managerial behaviour.

Because widely held firms are characteristic of corporate America, both the mass media and the academic research literature have dealt extensively with instances of self-serving management in widely held firms. The hit movie "Other People's Money" and the high-profile attention newspapers now give to poison pills, greenmail, and other instances of managerial misbehaviour testify to the extensive public awareness (if not always understanding) of corporate governance issues in widely held firms.

Closely Held Firms: Entrenched Insiders?

As the study by Rao and Lee-Sing (1995) shows, most large Canadian firms are not widely held. In more than three-quarters of the Canadian corporations they examine, at least one large blockholder controls 20 percent or more of the voting shares, and in over half of the firms a single blockholder controls more than 50 percent of the voting shares. Large shareholdings by management often enable them to dominate shareholder meetings since most small shareholders do not attend. This allows management to control director appointments and thus indirectly control corporate decisions. Under these circumstances, it is unlikely that senior managers would ever forget about dominant shareholders' interests for long. Given this, one might think Canadians would rejoice that most of our large firms are free of American-style agency problems. Unfortunately, the ownership structure of Canadian firms does not entirely eliminate these problems, and it brings with it another set of agency problems.

In closely held firms, the fear is that directors and officers will toady excessively to the dominant shareholder and ignore smaller investors. Consequently, their fiduciary duty to act in the interests of the corporation is interpreted to mean acting in the interests of all the shareholders. The agency problem here is the possible conflict of interest between the dominant shareholder (supported by the officers and directors who are under the dominant shareholder's control) and the other shareholders.

There is considerable evidence from the United States that blockholders do extract private benefits from firms. Barclay & Holderness (1989, 1992) show that large blocks of stock are generally transferred at prices higher than those prevailing on the open market for the same shares. Presumably this is because large blocks of shares confer more benefits than small stakes. Barclay, Holderness & Pontiff (1993) make the further case that the prices of many closed end funds in the United States are depressed because controlling blockholders extract private benefits. There is no reason to assume Canadian blockholders are more altruistic than their American peers.

Dominant shareholders are perhaps less likely deliberately to push the firm toward non-value-maximizing activities of the sort described in connection with widely held firms. After all, the dominant shareholder pays a high percentage of the cost himself. However, it is not reasonable to rule out such behaviour entirely. Large blockholders often dominate shareholder meetings with 20 percent of the stock or less. A decision that costs the firm \$5 million is clearly not in the interest of a 20 percent dominant blockholder unless it also generates private benefits she values at more than 20 percent of \$5 million, or \$1 million. Certainly, such situations are not impossible.

An additional set of potential problems in closely-held firms involves what financial economists call "entrenchment". Dominant blockholders who exert a detrimental influence over corporate policy are almost impossible to remove; they are largely immune to takeovers, proxy challenges and board rebellion. Unfortunately, some dominant shareholders who originally brought value to their companies may continue to exercise control long after they should have retired.

There is substantial evidence that managerial entrenchment is also common. Morck *et al.* (1988) show that in the United States firm performance rises with insider ownership for widely held firms, but then falls as ownership levels rise above a threshold that permits entrenchment. Johnson *et al.* (1985) show that sudden deaths of CEOs over the age of 70 cause their firms' share prices to rise on average. Often, the death of a firm's dominant blockholder leads to it becoming widely held as the heirs cash out. However, the inheritance of dominant blocks of stock can also put less competent heirs into positions of power they have not earned. Morck & Stangeland (1994) find that Canadian firms whose dominant shareholders are their founders' heirs perform significantly worse than other firms of the same age and size in the same industries.

Firms with Dual-Class Shares: The Worst of Both Worlds?

Canadian law and practice allow companies free reign to issue multiple classes of shares with different voting rights. This, in theory, allows closely held firms to grow without the dominant blockholder losing control. In practice, many fear that it also opens Canadian firms to the worst of both worlds. By issuing themselves stock with many votes per share, while others hold shares with few or no votes, dominant shareholders can entrench themselves although they own only a tiny fraction of the firm.

Dual-class recapitalizations (i.e., transformations of one-vote-per-share firms into firms with different classes of voting stock) can be coercive. For example, suppose small shareholders in a one-vote-per-share firm are given two weeks either to convert their common stock into class B common stock that will have no votes but will pay an extraordinary dividend, or to commit to retaining their existing common shares (renamed class A common) that do have votes. On the one hand, each small shareholder knows that if all the others convert and she retains her class A stock, she will miss out on the extraordinary dividend and be left with a vote that is essentially useless. Thus, she should convert. On the other hand, if all the other shareholders retain their class A shares, if she chooses to convert her share to class B, her action will not, by itself, allow management to become entrenched; so she might as well have the dividend. Thus, again, she should convert. In essence, each small shareholder is enticed to convert her stock to non-voting common, despite the fact that this course entrenches management and reduces the value of the firm. Jarrell & Poulson (1988) show empirically that dual-class recapitalizations tend to lead to entrenchment and depress firm values.

At present, there are two specific ways in which corporate and securities law constrain the scope for opportunistic recapitalizations. First, it is open to shareholders to undertake a derivation action or seek an oppression remedy on the grounds that such conduct is motivated by an improper purpose. Such a claim would be salient in the context of a share recapitalization effected in the context of a hostile takeover bid. Second, both corporate law (provisions respecting fundamental changes) and securities law (e.g., *Ontario Securities Policy 1.3*) require special shareholder votes when dual-class share structures are created. These votes enable dissident shareholders to object to opportunistic dual-class recapitalizations.

Firms with Takeover Defences: Protecting Shareholders from the Temptations of Wealth?

Hostile corporate takeovers are events that often pit incumbent managers and workers against shareholders. Takeover bids are always good for shareholders because tender offers to buy control are generally made at premia of more than 30 percent above previous stock market prices, and can be much higher. It is difficult to see why shareholders need to be protected from selling their stock on such favourable terms. Indeed, shareholder rights activists argue that takeover defences exist primarily to entrench top managers who have established comfortable positions for themselves.

This view may be excessive. In some circumstances it is in the interests of the shareholders to have a takeover delayed so alternate buyers can be found. If a bidding war can be started, the ultimate takeover price might be increased even more. With this justification, many large Canadian firms have constructed defences against hostile takeovers.

Poison Pills

These are amendments to corporate charters that penalize shareholders who acquire more than a certain amount of stock. For example, a flip-in poison pill might declare anyone who buys more than 15 percent of outstanding voting stock to be an “acquiring person”, and then go on to say that in the event anyone becomes an acquiring person, all other shareholders except the acquiring person shall receive 10 free shares for each share held. This reduces both the value of the acquiror’s position and its voting strength by 90 percent; the acquiror is virtually back where she started.

In Canada, shareholders must vote on (i.e., approve) poison pills. However, in some cases the vote is tied to other issues, such as increased dividends, which casts doubt on the extent to which shareholder approval is truly voluntary. Nevertheless, the Canadian strain of poison pills is much less virulent than its American counterpart, which suggests that the requirement to obtain shareholder approval has limited somewhat the scope for opportunism. Even more significantly, there have been several setbacks for poison pills in Canadian courts and securities commissions.⁹ The general thrust of these decisions is that poison pills may buy time for managers to conjure up another offer for shareholders, but ultimately shareholders must be given the opportunity to decide whether or not they want to tender their shares to an offer.

Voting Caps

Many corporations that have been established by Acts of parliament, such as chartered banks and privatized Crown Corporations like Air Canada and PWA Corp., have legislative voting caps.. These conditions, set out in the statutes that created the firms, make it illegal for any shareholder to own more than minimal amounts of the firms’ shares. In the case of Air Canada, the limit is 4 percent. For the banks, the limit is 10 percent. Voting caps are merely extreme forms of poison pills.

Takeover Rules

Under Canadian securities laws, a takeover bid is defined as any offer to acquire an issuer's equity that would confer more than 20 percent ownership of a single class of shares on the offeror. Once a takeover is deemed to have occurred, the acquiror must comply with certain rules, including *pro rata* take-up of shares, minimum bid periods, information disclosure obligations, and so on. For purchases of control from dispersed shareholders, the rules of Canadian securities law do not operate much differently from those of the United States. The crucial difference is in the context of sale of control by an existing control holder. Whereas these transactions are subject to only selective *ex post* review for substantive fairness in the United States, in Canada, the entire takeover regime applies to these transactions, thereby entitling all shareholders to participate *pro rata* in the transaction. The effect of this rule is to raise the costs of a change in control transaction for an interested acquiror. Because an existing control blockholder is unlikely to want to part with only a portion of her holdings (minority status is an unattractive prospect for a controlling shareholder), the acquiror is forced to bid for 100 percent of the company's shares. Many financial analysts regard this as a thinly disguised anti-takeover rule. By striving to make takeovers utterly fair, we may have made many of them prohibitively expensive.

Do takeover defences ultimately benefit shareholders? The preliminary answer appears to be "no". Empirical evidence suggests that on average takeover defences do have an entrenchment component. Stangeland (1994) finds that firms with poison pills record performance levels below those of industry rivals without such anti-takeover defences. Other recent studies also find that the adoption of poison pills and other takeover defences is correlated with reduced share value. A recent study by Comment & Schwert (1995) appears to contradict this, however.

Firms with Free Cash Flow

Harvard Business School professor Michael Jensen suggests that corporate financial policy is closely related to corporate governance issues. He theorizes that in mature industries, a firm's existing operations produce substantially more cash flow than is needed for profitable capital investments. This excess he calls "free cash flow". Firms should use cash flows they cannot profitably use internally to pay increased dividends. In firms with inadequate corporate governance, managers may seek to retain control over their firm's free cash flow by retaining it for suboptimal investments. According to Jensen (1986), a low dividend rate in a mature industry is strong evidence of poor corporate governance. He also suggests that, in order to prevent managers from mis-investing funds, firms in cash-rich, mature industries should be more highly levered. Thus, there is a high probability that cash-rich firms with low debt are also subject to poor corporate governance.

The study by Gagnon and St. Pierre (1995) takes a preliminary cut at Canadian data and finds no evidence of a systematic link between leverage or dividend policy and performance. More specific empirical tests, analogous to those undertaken in the United States, have not yet been performed for Canada.

Conglomerates: A Shell Game?

In Canada, as in continental Europe, Korea and Japan, much corporate activity is undertaken by conglomerates that consist of numerous related firms that collectively own controlling blocks of each others' stock. Public shareholders own the remaining shares at each level.

There are many valid reasons in economic theory to explain the existence of conglomerates. It is costly for firms to raise external capital. Financing investment projects is simpler and cheaper if it can be done using internal funds. Conglomerates can serve as a sort of internal capital market for member firms. Excess cash from one firm can be invested in another if the return there is higher. If conglomerates are run by managers who understand and can control all its diverse parts, they should make considerable economic sense.

However, the performance of conglomerates in general has not lived up to such expectations. Lang & Stulz (1992) show that the performance of conglomerates lags behind that of focused firms. Also, the collapses of conglomerates like Argus, Olympia & York and the HeesEdper group of firms have added to investors' doubts about the real economic value of conglomerates. In the United States, conglomerates constitute a disproportionate share of hostile takeover targets. Raiders there have found the share prices of some conglomerates to be so depressed that money can be made by buying the whole conglomerate, breaking it up, then selling all its parts separately. In these cases, at least, the parts are worth considerably more than the whole.

The underlying problem with conglomerates is widely perceived to be that they are much more difficult to manage than focused corporations. It is difficult, if not impossible, for the head-office managers in a conglomerate to understand each component business thoroughly enough to formulate strategies that are as effective as those of their more focused rivals. This undercuts the main advantage of a conglomerate – the alleged allocation of the group's capital to where it earns the highest return. But more than that, conglomerates open up a whole new type of agency problem.

By controlling interfirm dividends, by having companies within the conglomerate group lend to each other at non-market interest rates, by organizing intercorporate billing for goods or services at artificial prices, or by transferring assets at synthetic prices, conglomerate managers can reduce profits in one firm and increase them in another. The fear is that profits in firms where insiders own relatively less stock might be diverted to firms where they own most or all of the stock – a kind of corporate shell game. In such a case, the agency problem is the plural version of that in a closely held firm: that the insider shareholder who controls the conglomerate might enrich herself at the expense of the public shareholders in all its firms.

An analogous problem arises for tax authorities in other countries when money flows from profitable, and therefore taxable, firms to loss-making firms within a conglomerate. This is not a problem here in Canada because tax-free payment of dividends within a corporate group is entirely legal.

In fact, as the study by Daniels, Morck & Stangeland (1995) points out, there are numerous other features of the Canadian legal and institutional environment that also facilitate conglomerate formation. Canada's current *Investment Companies Act* is a less effective barrier to establishing

conglomerates with large numbers of partially owned subsidiaries than is the *Investment Company Act* of 1940, and its requirements can easily be avoided through provincial reincorporation. More liberal interest deductions in Canada subsidize debt, which provides favourable financing for acquisitions. The lack of a vigorous, privately enforced securities disclosure regime in Canada reduces the transparency of internal corporate transactions, and heightens the attractiveness of the conglomerate form of organization to opportunistic corporate insiders. Similarly, the lack of a clearly articulated corporate law fiduciary duty from majority to minority shareholders in Canada helps explain, at least historically, the attraction of conglomerates to opportunistic controlling shareholders. The absence of such fiduciary duties allows controlling shareholders greater scope for unfair self-dealing than would be possible in the United States.

Daniels *et al.* also argue that the mercantilistic industrial policies of successive Canadian governments encouraged conglomerate formation. Restrictions on foreign investment by Canadians, such as the foreign property rule in the *Income Tax Act*, reduce Canadian shareholders' investment opportunities. When they may disagree with the policies of corporate managers, shareholders here have fewer alternative places to put their money than would be the case if they could freely invest abroad. This may have allowed inefficient conglomerate holding structures to survive, and may thereby have prolonged wealth-reducing redistribution from investors to Canadian corporate insiders. Trade protectionism and favourable tax treatment of certain types of domestic equity investments also contribute to an inward looking industrial economy. Canadian corporations have focused on producing a broad range of goods and services for the protected Canadian market rather than on a narrow range of competitive products for the global market. In this setting, the diversified conglomerate serves as a natural vehicle for achieving corporate growth. Further supporting the formation of the conglomerate was, in sharp contrast to the United States, a more congenial political environment for the concentration of economic power. Whereas American political traditions embody a deep and abiding mistrust of concentrated economic power, the Canadian political environment is more sanguine. Here, the development and preservation of a fragile national identity easily overcame concerns about concentrated power. So, to the extent that economic concentration may be the inexorable result of nationalism, Canadian political leaders have regarded it as a price worth paying to promote collectivist goals.

Multinationals: A Global Shell Game?

Multinational corporations are multi-firm organizations akin to conglomerates, but with a more convincing economic rationale. All the subsidiaries of a multinational are usually in the same line of business so the overall organization is easier for head-office management to run than is a cross-industry conglomerate. Moreover, multinationals have immediate access to markets in many countries. This can be critical in earning a quick high return on expensive investments like R&D. For investment in innovation, production and marketing costs are often minimal compared to upfront R&D costs. Thus, the larger the firm's market for its new product, the higher the return on its original R&D. For firms in R&D-intensive industries like pharmaceuticals, computers, telecommunications equipment, home electronics, etc., a multinational structure is almost essential. Foreign partners are often avoided in these industries because of a fear of reverse engineering or the theft of proprietary information. The same considerations apply in other industries with high up-front fixed promotion

costs like music recording or films, although foreign partners are a more practical alternative there. Morck & Yeung (1991, 1992) present empirical evidence that foreign subsidiaries do, in fact, add value only for firms with high spending on R&D or advertising.

There is, however, another reason for a multinational structure: tax avoidance. By shifting profits between subsidiaries (employing the same methods used by conglomerates) multinationals can control which subsidiaries are the most profitable and hence the most taxable. Harris *et al.* (1993) provide empirical evidence that U.S. multinationals commonly shift income from highly taxed to less-taxed subsidiaries. Canada has higher taxes than many of the other countries in which multinationals operate. Given higher domestic tax rates, multinationals operating in the Canadian environment have strong incentives systematically to shift profits out of Canada through manipulation of transfer pricing schemes. Not only does such behaviour reduce the revenues flowing to the Canadian branch, it also reduces the wealth of Canadian investors who hold minority stakes in the multinationals' subsidiaries. This phenomenon illustrates poignantly the law of unintended consequences; the creation of partially owned foreign subsidiaries was encouraged by Canadian tax and foreign investment policy.¹⁰

Cooperatives: The Members' Money?

A number of industries that are made up of corporations in other countries contain cooperatives in Canada. These organizations are owned by their members but controlled by professional managers. Thus, in theory, they might share many of the problems of lack of managerial accountability that afflict widely held firms and firms with entrenched management.

Crown Corporations: Taxpayers' Money?

Despite a series of privatizations during the 1980s, Crown Corporations are still very much a part of the Canadian business scene. Corporations like the CBC, Alberta Treasury Branches, Ontario Hydro, and BC Tel. are unlikely to face privatization any time soon. Universities and hospitals are likely to remain in the public sector too. Given the agency problems that pervert decisions in the private sector, is not public-sector ownership an attractive alternative?

The answer is an emphatic "no". Megginson, Nash & Van Randenborgh (1994) show that the performance of state-controlled enterprises, including those only partially owned by the state, is unambiguously worse than that of similar private sector firms. This begs the question, "why?".

The reason seems to be that state-owned enterprises have their own set of agency problems that are, in many ways, more intractable than those of private-sector firms. In principle, Crown Corporations are supposed to be run in the public interest. In practice, this often means they are run in the interests of politicians and political appointees who pay none of the substantial costs of poor investments, empire building, etc., compared to the small fraction of such costs incurred by the managers and dominant shareholders of private-sector firms. The overriding agency problem in public-sector firms is that politicians and political appointees tend to lose sight of their duty to the public. Moreover, dysfunctional corporate governance in private-sector companies is ultimately constrained by the firm's bottom line and the bankruptcy that its violation triggers. State-owned

enterprises have what economists call “soft” budget constraints — their deficits are picked up by the taxpayers. State-owned enterprises can thus tolerate worse governance than can their private-sector counterparts. Furthermore, those mechanisms that limit agency problems in private firms, such as shareholder votes, takeovers, project-based capital market scrutiny etc., are not features of the governance of state-owned enterprises. The only restraining lever the public holds is the threat of electing politicians who will privatize, and this is being exercised increasingly often.

Other Nonprofit Enterprises: Donors’ Money?

The largest charitable organizations can be as big and complex as large corporations. Their top executives have responsibilities on a par with those of corporate executives, and make decisions involving as much money. Yet charitable organizations have nothing analogous to shareholder votes, annual reports, etc. To provide accountability, director liability rules do extend to charities, even small local organizations. Is this the best way of making sure the managers of the charity act as their donors expect?

4. OPTIONS FOR IMPROVING CANADIAN CORPORATE GOVERNANCE

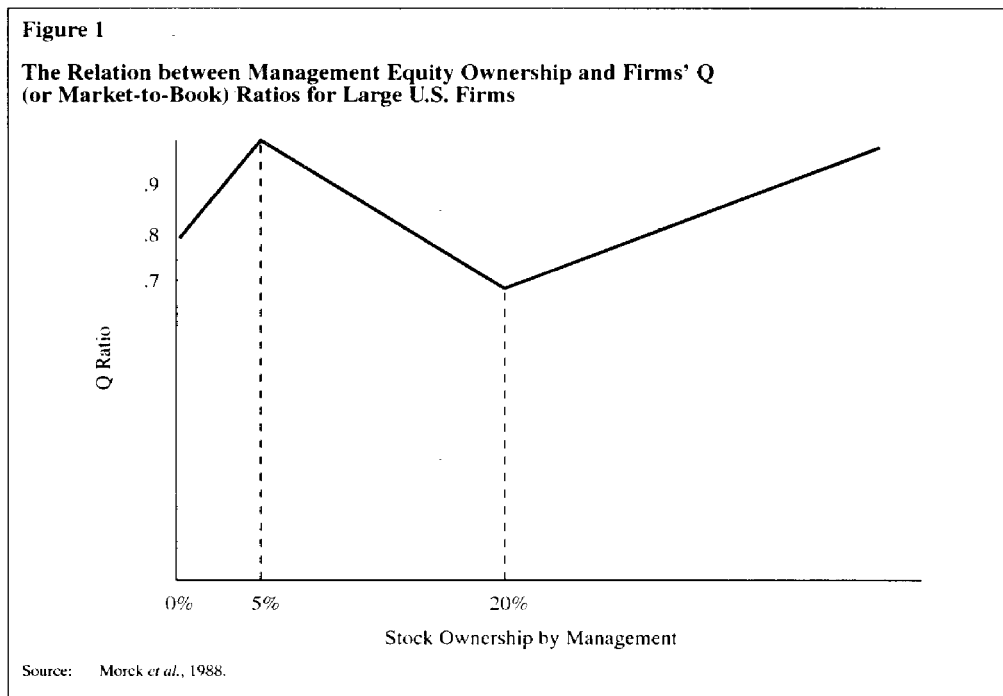
Managerial Equity Ownership

If managers own shares in their own corporation(s), they should be less willing to make decisions that are likely to reduce share prices. Thus, share values should generally be higher when managers own more stock. At some point, however, increasing ownership begins to entrench management. Consequently, when that point is reached, share values should begin to fall as management ownership rises. This pattern is found in data for large U.S. firms by Morck *et al.* (1988), and is illustrated in Figure 1. Share value rises with stock ownership by management, except in the range between 5 percent and 20 percent, suggesting that this is the range within which entrenchment occurs.

Other studies confirm this general pattern, although there is disagreement as to exactly which ownership levels correspond to entrenchment. For example, McConnell & Servaes (1990) place the entrenchment range around 40 percent, but they use smaller firms for most of their analysis. Also, their findings do not include an upward sloping segment beyond 20 percent. Both their result in this range, and that of Morck *et al.* (1988) are tenuous because of the scarcity of data on publicly traded, closely held firms in the United States.

Amoako-Adu and Smith (1995) provide a similar analysis for Canadian firms. They find no statistically significant pattern in the data for firms with insider ownership below 20 percent. This could be due to the small number of Canadian firms in that range, or to the fact that in Canada stakes below 20 percent are not generally disclosed, or both. However, among firms with more than 20 percent managerial ownership, they find a positive relationship with share value, similar to that found by Morck *et al.* (1988). Rao and Lee-Sing (1995) find no linear relationship between insider ownership and firm performance, but do not search for a nonlinear relationship of the sort shown in Figure 1. Jog and Tulpule (1995) divide firms into four groups ranging from very low to very high levels of insider ownership and find no difference in their long-term returns to shareholders or their accounting performance. As they recognize, an important limitation of their stock market analysis is that it looks only at returns. Consequently, if the stock prices of some of their firms (say, the widely held firms) were depressed due to their ownership structures by roughly the same amount throughout the period studied, they would find exactly the same result. Their study does show, however, that between 1977 and 1981 there was no statistically significant change in the relative pricing of stocks in widely held versus closely held firms. Also, their accounting-based results are not strictly comparable to Rao and Lee-Sing (1995) or to other studies in the research literature because they are not compared with industry and firm-size benchmarks.

On the whole, we share Barone-Adesi's (1995) lack of surprise that results obtained for U.S. firms do not hold up in Canada. There are many institutional differences between the two countries (Daniels & MacIntosh, 1991 and MacIntosh, 1993). Canadian managers are relatively free of class-action suits by shareholders and can use dual-class shares to retain control despite issuing large amounts of equity. Also, friendly sales of control are more difficult in Canada because of legislated



equal-opportunity rules, and Canadian institutions may be more passive on corporate performance issues. All of these differences make management entrenchment easier in Canada. The studies by Amoako-Adu and Smith (1995), and by Rao and Lee-Sing (1995) are both consistent with the view that most Canadian firms already have entrenched management, so increasing insider ownership further is more likely to increase than depress share prices. In this context, Canadian firms are located along the farthest right segment of Figure 1. Share values are already depressed by full entrenchment, so further increasing insider holdings can do little, if any, harm. Therefore, if managers are equally entrenched by holding 50 percent or 60 percent, it is preferable that they own 60 percent; then their personal interests are at least marginally closer to the firm's.

If this view were confirmed by overwhelming evidence, it would support a policy of actively encouraging greater insider ownership among firms that already have dominant shareholders. However, the evidence is not yet overwhelming. Jog and Tulpule (1995), for instance, are not supportive of this, although their methodology is aimed at addressing other issues and is ill-suited to answer this question. Because we consider the evidence to be too equivocal to support a robust policy recommendation, we make the following, more modest, suggestion.

Policy Implication 1

- Government should neither encourage nor discourage any level of insider ownership.

Outsiders on Boards of Directors

The *Canada Business Corporations Act* currently requires at least two unrelated directors on the board of a public firm. In theory, these outsiders monitor management and publicize, if not prevent, decisions that might depress share values. Weisbach (1988) shows that U.S. firms whose boards have outsider majorities are more likely to sack their CEOs following unusually poor financial performance than are firms with boards dominated by insiders. Also, Rosenstein & Wyatt (1990) find that the share prices of U.S. firms tend to rise with the news that outsiders are coming onto their boards. However, Hermalin & Weisbach (1991) find no statistically meaningful relation between outsiders on the board and share values. These findings can be reconciled if outside directors have little effect under normal circumstances, but force action when performance is very bad. Despite this decidedly mixed evidence, the Toronto Stock Exchange Committee on Corporate Governance in Canada (the Dey Committee) recommended that a majority of all directors of listed companies be unrelated.

It is important to note that Weisbach's (1988) result is for the United States where most firms are widely held. In Canada, most firms are closely held and their top managers are arguably entrenched. Also, the clout of outside directors may be decidedly limited when the CEO controls a majority of shareholder votes. In a closely held economy, does having outsiders on the board really matter?

The evidence is that it does not seem to matter. Neither Amoako-Adu (1995) and Smith nor Gagnon and St-Pierre (1995) finds any statistically discernible relation between the percentage of outsiders on the board and firm performance. Rao and Lee-Sing (1995) actually find a positive relation between several performance measures and the percentage of *insiders* on the board. These findings are consistent with recent work by Hermalin & Weisbach (1995), who argue that rules requiring a certain percentage of the board to be outsiders are likely to be ineffective because dominant shareholders and managers can always find compliant and passive outsiders. They argue that outside directors must be given both more power and stronger incentives if they are to improve economy-wide corporate governance.

It may, however, be too early to give up on outside directors. Amoako-Adu and Smith (1995) make the valid point that Canadian disclosure rules often fail to establish whether outside directors are truly independent. For example, unrelated directors who are also the lawyers or accountants for the firm, or for its controlling shareholder, cannot be considered to be truly independent. The same is true for executives of companies that are suppliers or customers of the firm, or of other firms controlled by its dominant shareholder. Such directors are less likely than truly independent directors to challenge the CEO for fear of jeopardizing their other business interests.

The Dey Committee recommended that the board be charged with the task of determining who among its members is unrelated, and then be required to disclose publicly the basis upon which that decision is made (subsequently adopted in TSE Bylaw No. 636). While this recommendation confers considerable latitude on shareholders and directors to craft governance arrangements tailored to specific circumstances, it comes at the cost of engendering some confusion among investors as to

what exactly “unrelated” means. Therefore, in response to the issue raised by Amoako-Adu and Smith (1995), we suggest the following.

Policy Implication 2

- The current requirement in the *Canada Business Corporation Act* –that there be a minimum of two public directors on the boards of public companies –should be retained. However, the definition of an outside director should be tightened considerably. For a firm to characterize a director as an outside director (in accordance with the *Canada Business Corporations Act*), that director should have no commercial link of any kind with the firm or its controlling shareholder(s). In other words, an outside director should be truly independent of management and owners. The controlling shareholder, the firm’s lawyers, its advertising account managers, the executives of firms dependent on it for business, etc. should not be considered as outside directors. We further recommend that firms be required to disclose *all* their directors’ commercial links, direct or indirect, with the firm and with *all* entities controlled by the firm’s controlling shareholder.

Hermalin & Weisbach (1995) point out that requiring a specific number of outside directors is, by itself, unlikely to improve corporate governance. They argue that outside directors must also be given sufficient power to influence management and sufficient incentives to use that power. We return to the issue of increasing the power of directors later in the chapter, but turn now to directors’ incentives.

One such incentive comes from director-liability rules, which, in our opinion, should be reasonable, focused and well-balanced. The present regime weighs on the side of severity. We suggest that the ultimate effect of overly-severe director-liability rules is to discourage good outside directors from serving on boards. Director liability should therefore be invoked only in carefully limited, sharply focused circumstances, or it will be counter-productive. Another more balanced, less severe –rational – incentive scheme is needed. We believe changes in the form of director compensation might accomplish this.

Paying outside directors solely in publicly traded shares, or call options on them, would make directors more attentive to shareholders’ interests. This would address the incentive issue raised by Hermalin & Weisbach (1995), and lead outside directors to exert a stronger influence on firm performance. Although compensation paid to outside directors is usually quite modest, linking it to the price of publicly traded shares would be an important symbolic reminder to directors of where their discretionary duty lies. We therefore suggest that governments adopt the following recommendation.

Policy Implication 3

- Outside directors should be paid solely in publicly traded stock or stock options. If options are used, their exercise prices should not be adjusted *ex post* when the

share price falls. (This practice, regrettably common in CEO compensation schemes, defeats the entire purpose of option-based compensation schemes, which is to link pay to performance.) A better way to maintain proper incentives as the market fluctuates is to define explicitly the exercise price as the value of a portfolio of the stocks of other firms in the industry. A director's compensation would then rise when the shares of the company outperform the benchmark portfolio of shares of industry rival firms. Director compensation, and how it is determined, should be fully disclosed.

The effect of this requirement would be to empower shareholders by giving directors stronger incentives to safeguard shareholders' interests.

An issue raised repeatedly in this context is the alleged myopia of shareholders. Directors, the argument goes, should not be paid in options or stock because the perspective of shareholders is too short-term, and the rosy long-term prospects of the board's plans are thus beyond markets' collective ken. Giammarino (1995) documents the large and increasingly conclusive empirical literature on this issue and thoroughly debunks the folk wisdom that shareholders are more myopic than managers. He shows convincingly that share prices respond sensibly to changes in firms' long-term prospects. Accounts to the contrary simply do not stand up to close scrutiny.¹¹

If director compensation is linked to firm performance, a related issue is whether good directors will serve in a firm where there is likely to be continued poor performance while a turnaround is engineered. A basic compensation could be built into options by setting their exercise prices below the current stock price. (We consider the Toronto Stock Exchange rule that now prevents this to be inadvisable, and we recommend that it be changed.) If the directors oversee a continued price decline (relative to the shares of other firms in the same industry) that renders their options worthless, investors are presumably collectively unimpressed by the board's long-term turnaround strategy. In such circumstances, shareholders would probably be relieved if the directors responsible for the decline resigned or were replaced. Presumably, not paying them would hasten the former and render the latter unnecessary. If, initially, a firm is unable to persuade an outside director to come onto its board, the interests of the shareholders would be better served by offering such a director more options or stock, rather than by offering cash. In our view, *there is no economic justification for a guaranteed component in directors' compensation*. After all, the people in whose interests the directors are supposed to act – the shareholders – have no guaranteed compensation either. We believe most directors would welcome a switch to stock or options as compensation if it were accompanied by the rationalization of director liability we suggest.

There are two dangers with respect to paying potentially unscrupulous directors in stock or options: insider trading, and stock price manipulation. Such directors might exercise their stock options when they know the stock is overvalued, and thus harm public shareholders; or they might actively orchestrate information releases or discretionary accruals in earnings to inflate the share price around exercise dates. There is considerable evidence in the accounting research literature that firms *do* manipulate information releases and accounting data in this way for other purposes. Nonetheless, one straightforward way to address this problem is to require that directors' stock or options be

unuseable until some time after they have left the board. If directors must wait, say, two years after leaving the board, until they can trade or exercise the stocks or options they receive as compensation, their information advantage over ordinary shareholders should be largely dissipated.

Under the proposals we advance here, the job of an outside director is likely to become more difficult. Public companies should therefore review their directorial compensation arrangements regularly to ensure that the level of compensation received by directors corresponds to the time, energy, and commitment required of them in a rapidly changing, highly complex business environment.

Board Size

Is small better? Rao and Lee-Sing (1995) find a negative correlation between board size and performance. There is also a strong conviction held by many practicing directors that the boards of some large Canadian corporations are already too large to allow effective decision-making. Nonetheless, in our opinion it would be inadvisable to legislate the number of directors on boards. We contend that large boards are a symptom of deeper governance problems rather than a fundamental cause of poor corporate governance. Rather than encumber firms with an array of laws aimed at such symptoms, public policy should address root causes. We believe the positive recommendations we set out here focus on those root causes and thus would empower shareholders to demand smaller boards where they might improve performance.

Policy Implication 4

- Governments should not attempt to control board size.

Separation of Powers

Rao and Lee-Sing (1995) find that in almost 66 percent of the Canadian firms comprising the sample for their study, the CEO does not chair the board. In contrast, in roughly 60 percent of the firms in their U.S. sample, the CEO does chair the board.

Among students of constitutional law, the separation of powers is widely considered to be an essential component of good government. Power in the public sector must not be concentrated in too few hands, or some day an error in judgement by the electorate might confer on a rascal unchecked scope for villainy. Does this recipe for good government also apply to good corporate governance? There is some evidence that it does.

Morck *et al.* (1989) find that boards are more likely to replace CEOs following unusually bad corporate performance if the CEO is not also serving as both president and chairperson of the board. Moreover, where the three positions are held by one person, poor firm performance tends to increase the odds of a hostile takeover rather than the dismissal of the CEO. Perhaps too much power in the hands of the CEO paralyzes the board and leaves the firm vulnerable to more drastic remedies like takeovers for poor governance.

Rao and Lee-Sing (1995) find no discernable relationship between firms' general performance and a separation of powers in either U.S. or Canadian data. (They actually find a positive relation between *concentration* of power and firm growth.) They do not explore whether or not Canadian boards might be more willing to dismiss CEOs subsequent to very poor performance, however.

Allowing one talented executive to assume greater power by acting as CEO and chairperson of the board may benefit shareholders by reducing, if not eliminating, "needless" discussion and by speeding up the decision-making process. However, the same can be said of a dictatorship. Arguably, the purpose of political democracy is to restrain great men: that is also the purpose of shareholder democracy. Yet despite this, we believe a legislative requirement that these roles be separated is unnecessary and might well be ineffective. A dominant CEO is as likely to find a compliant and passive chairperson of the board as to find compliant and passive outside directors.

The purpose of separating the roles of chairperson and CEO is to foster a climate in which dissident directors can confront a CEO or a controlling shareholder. Elsewhere in this commentary, we propose both better disclosure and conduct committees as ways to accomplish this. In our opinion, this represents a better general strategy to ensure that shareholders are empowered and informed; they can then elect whom they please to chair the board.

Policy Implication 5

- Governments should not legislate a separation of the roles of CEO and chairperson of the board.

CEO Compensation

In Canada and the United States, CEO compensation is a hot topic. As Elitzur and Halpern (1995) point out, in the United States CEO compensation is thought by many to be too high and, more importantly, too unrelated to corporate performance. Presumably, most shareholders would not mind high CEO pay if it were related to superb performance. However, if CEOs can continue to earn the same compensation no matter how well (or badly) they run their companies, this is clearly a problem.

It is important to emphasize that this problem is mainly confined to widely held firms. In closely held firms, especially where the dominant shareholder is also the CEO, the firm's fortunes are intertwined with those of the CEO. In such cases, tying compensation to firm performance through salaries, bonuses or option plans is redundant.

In Canada there are some widely held firms, and sometimes the managers of closely held firms are not their dominant shareholders. In such cases, tying executive compensation to firm performance makes sense. Elitzur and Halpern (1995) argue that in these firms CEO compensation is not tied closely enough to performance. We do not believe requiring a closer tie is wise. A better policy would be to empower shareholders in more basic ways and then allow them to determine appropriate compensation packages for CEOs.

Stock options are one alternative shareholders should reconsider. These have deservedly earned a bad name in recent years because of the willingness of boards to rewrite their terms at the CEO's request. For example, if a CEO were given options to buy his company's stock at \$50 and the share price fell to \$25, the board too often happily rewrites the options to let the CEO buy at \$20. CEOs and boards rightly understand that a CEO cannot be held responsible for every movement in her firm's stock price. However, allowing options to be adjusted freely in this way can protect the CEO from stock price declines that are her responsibility.

To sidestep this, we suggest that firms pay their CEOs in options with adjustable exercise prices tied to the stock price performance of rival firms. The CEO's stock option could let her buy a share of her company's stock at a price that moves up and down with the share prices of other firms in the industry. This would adjust the terms of the option when industry-wide or economy-wide factors affect the share price, yet would still hold the CEO accountable when her own firm's share price alone rises or falls.

Policy Implication 6

- CEOs should be paid in stock options. These should partially or completely replace salaries, not supplement them. Boards should not be allowed to revise the terms of such options after they are issued. To protect CEOs from price fluctuations beyond their control, the exercise prices of their options should move automatically with industry or market indexes. A CEO compensated in this way should not be subject to excess compensation suits if she achieves superior performance relative to her industry rivals. In addition, CEO compensation and the way it is determined should be disclosed.

It is important that CEOs share some of their shareholders' downside risk. Therefore CEOs should originally be compensated with in-the-money options¹² in order to produce expected compensation sufficient to attract and retain highly qualified CEOs. Although we understand the sentiments that led to it, we believe the current TSE rule forbidding in-the-money options should be changed. As it is now, the rule prevents options from replacing salary and bonuses, yet leaves open the possibility of huge amounts of compensation.

We recommend against tying CEO compensation to accounting performance measures such as earnings. These are too subject to manipulation. By timing accruals, for example, managers can manipulate current earnings to almost any extent desired. Elitzur and Halpern (1995) provide a quick overview of the extensive empirical evidence that this does occur. Of course, stock prices can also be manipulated by orchestrating information releases. To prevent this, CEOs' options, like those of directors', should not be exercisable until after retirement.

If a CEO's pay is to be geared to her firm's stock market performance, that CEO must also be permitted to reap the rewards – in the form of very high pay – when the firm's performance is superior. There has recently been much grumbling in Canada about the magnitude of CEO pay. In

the United States many lawsuits by shareholders against managers are “excess compensation” suits. Jensen (1990) argues that the real scandal is not the size of the CEO’s pay, but its failure to reflect firm performance. He contends that the fear of excess compensation lawsuits partly explains why CEO pay in the United States is not closely tied to performance. CEOs there are unwilling to accept low pay when firm performance is poor because they doubt that they will be able to keep high pay when firm performance is good. Because of this, some argue that CEO pay should not be disclosed in order to allow it to be tied more closely to firm performance without raising shareholders’ ire. We believe this would be unwise.

It is in the public interest that shareholders know how much money top insiders are taking from the firm. We therefore endorse strongly the recent changes to the Regulations under the *Ontario Securities Act*, which require more extensive and detailed disclosure of executive compensation practices. However, while there is value in disclosure, it is also in the public interest that good management be rewarded. Thus, when a manager receives very high compensation from an option-based incentive scheme that seemed reasonable at the time it was instituted and that shareholders accepted at the time, lawsuits alleging excess compensation should not be allowed.¹³

We do not believe government should legislate how CEOs are paid. Our suggestion with respect to the use of options with moving exercise prices is directed mainly to shareholders and boards of directors. It is important, however, that governments continue to require disclosure of CEO and top executive compensation, and that the courts are not required to hear excess compensation suits where high compensation derives from superior performance.

Director Liability

There has been a growing trend in Canada toward increased directors’ liability. In contrast to the United States, Canadian legislatures are inclined to support explicitly legislated corporate duties and obligations with explicit liability for directors. One researcher recently identified no less than 106 different federal and provincial statutes that impose personal liability on directors and officers in Ontario. There has also been an increase in non-statutory, typically tort-based, liabilities. It is noteworthy that this expansion in liability has occurred without any substantial change in the corporate law relating to duty of care, which governs the liability of directors and officers for negligence.

The rationale alleged for legislating these duties is straightforward: directors must have strong incentives to monitor corporate activities and prevent corporate wrongdoing. However, while there may be a need for increased control of corporate wrongdoing in Canada, it is not at all clear that the imposition of personal liability on directors is an effective way to achieve this goal. Imposing liability on directors not only fails to provide consistent and compassionate levels of recovery to injured stakeholders (owing to vagaries in the personal resources of directors), it may also bias directorial decision-making in the direction of low-risk, unimaginative projects (Daniels, 1994). In a setting of intense competitive pressures, a board gripped by fear because of its liability is an uninspired instrument for vigorous and creative leadership. Even worse, fear of liability may cause the board to resign when its leadership and expertise are most needed (when, for example, a firm is near

insolvency) and the threat to stakeholder interests is greatest – the so-called “board overboard” phenomenon (Daniels, 1993). Indeed, fear because of personal liability under provincial employment standards legislation has resulted in en masse resignations of board members from troubled public companies in Canada (e.g., PWA and Westar).

These problems are accentuated by various weaknesses in Canadian corporate director and officer insurance policies. Daniels & Hutton (1993) find that, as a specialty or fringe line of insurance, the supply of director and officer (D&O) coverage is subject to abrupt and quite dramatic fluctuations, as measured by several variables: price and deductible increases, growth in coverage exclusions, and compression of coverage periods. The use of these restrictions means that, at some points in the insurance-cycle, coverage for certain D&O liability risks is literally unavailable at any price. For example, in 1987, 91 percent of the insurance policies written in Canada excluded liability for pollution and environmental damage and 17 percent excluded liability for actions taken by various regulatory agencies. Furthermore, most insurance policies were written on a claims-made basis and allowed for only relatively short discovery periods after termination. The net effect of these restrictions has been to make trusting D&O insurance an extremely speculative strategy for most directors.

To address these problems, we recommend the following.

Policy Implication 7

- Directors should be liable to class action suits by shareholders for explicitly legislated corporate responsibilities *provided that the directors’ act or omission is the reasonably proximate cause* of the harm in question. This liability should never be absolute — it should always be subject to a *due diligence defence*. Directors and officers who exert a reasonable effort to uncover and prevent potential harm to shareholders should be protected from lawsuits. Directors who go on the record as opposing decisions later found to have harmed shareholders or stakeholders should also be protected from lawsuits arising out of those decisions. We endorse the recommendation of the Dey Committee that the government departments responsible for the administration of corporate law in their jurisdictions undertake systematic and comprehensive reviews of all legislation that imposes personal liability on directors and officers to ensure that the provision is cost-effective as measured against the policy goals sought.

It is our expectation that much of this legislation will not justify its cost. In cases where social responsibility, the environment and other broad public objectives are being backed up with director liability, such liability should be capped, at least for outside directors. It might also be reasonable to cap outside directors’ liability for breach of duty of care, as this duty can be somewhat open ended. We would not, however, limit the exposure of directors for either oppressive conduct or breach of the duty of loyalty, both of which involve aspects of self-dealing.

Generally, there has not been any expansion in the scope of liability under the corporate law duty of care. This is desirable since, by and large, courts are ill-equipped to second guess directorial business decisions. The danger is that, in order to be able to point the finger at someone when corporations lose money, shareholders will attempt to hold directors and officers responsible for actions that were perfectly responsible at the time they were made. Corporate decision-making is inherently about risk-taking, and it is undesirable for directors to be held liable for legitimate risks that later turn sour. This is why courts have traditionally strained against the imposition of liability for business decisions and judgements that are well-informed and not tainted by any hint of self-interest; it is also why we believe director liability should be precisely defined and subject to a due diligence defence.

Another reason is the serious risk of deterring competent outsiders from accepting positions on boards if liability rules are too strict. The responsibilities of directors and officers should be limited to what they can reasonably be expected to control. There are better tools for improving corporate governance than broad and open-ended liability for officers and directors. This is especially true for outside directors who benefit little from firms' exploitation of their shareholders yet who may bear huge liabilities. Imposing excessive liability undoubtedly deters highly qualified people from serving as directors, especially in troubled firms where there is a high likelihood of legal action. Yet these are the firms where competent outsiders are most needed.

We believe directors' responsibility should be simple and clear: maximize share value. The substantial body of empirical literature discussed by Giammarino (1995) suggests that the allegations of shareholder myopia and related criticisms of financial markets are largely unjustified. Although financial markets may be subject to occasional irrational fluctuations, for the most part share prices move in response to investors' rational perceptions of a firm's performance and long-term future prospects. Share prices are valuable, though admittedly imperfect, measures of how well shareholders think the firm is doing. Except for annual shareholder meetings, no other such gauge of shareholders' views is available. Therefore, we feel the law should recognize financial markets as delivering a democratic, albeit imperfect, expression of shareholders' opinions.

Policy Implication 8

- The shareholders' interests in a derivative suit should be defined as the *maximal current share value*.

Although earlier studies came to conflicting conclusions, there is now fairly widespread acceptance that management entrenchment devices like poison pills lower share prices. We concur with Huson's (1995) suggestion that these sorts of effects be factored into valuation calculations in such suits.¹⁴

Controlling Shareholders

Canada's is a closely held economy, and *dealing with controlling shareholders is consequently the central issue in Canadian corporate governance*. In our judgement, the policy

implications in this section are the most important in this volume. Although the studies here do not point to pervasive problems related to controlling shareholders, the same methodological difficulties we discussed when interpreting them as to the desirability of fostering more or less concentrated ownership apply here too. Moreover, there is considerable evidence in the corporate finance research literature that concentrated ownership can be a problem. Holderness & Sheehan (1988) show that different types of dominant shareholders have different effects on U.S. firms' performance. Along these lines, Morck & Stangeland (1995) find that the performance of Canadian firms is depressed when the controlling shareholder is an heir, but not otherwise. The studies of large blockholders in the United States cited by Holderness (1995) also provide ample reason for concern. Finally, there is a large body of empirical evidence from other countries, reviewed at length in Shleifer & Vishny (1995), which concludes that dominant shareholders do extract significant value from firms they control. The preponderance of evidence, we believe, supports an active public policy in this area. However, we believe the primary goal of public policy here should be the empowerment of shareholders and outside directors.

The high level of share ownership concentration in Canada makes problems between controlling and minority shareholders the crucial axis of agency conflict. The problem is not one of managerial fidelity to shareholders, but rather one of fidelity to some shareholders – controllers – at the expense of others, minorities (Daniels & MacIntosh, 1991). As MacIntosh and Schwartz (1995) argue, controlling shareholders usually make the corporation's managers work harder, but the rub is that the fruits of such effort may not go equally to all shareholders – the controlling shareholder can siphon off a disproportionate share.

In this setting, it is indeed ironic that Canadian courts (in contrast to their American counterparts) were loathe to develop a clear fiduciary duty from majority to minority shareholders (see MacIntosh, 1993, for a thorough discussion of this issue). Indeed, in a closely held economy such as ours, a clear fiduciary duty of dominant shareholders to minority shareholders along the lines of French law, described by Barone-Adesi (1995), would seem appropriate.

This omission has been redressed through the adoption of the statutory oppression remedy in federal and provincial corporate law, and through the development of a range of minority shareholder protections in provincial securities law, such as Ontario Securities Commission Policy 9.1. which sets out disclosure, valuation, disinterested director review, and shareholder approval requirements for insider bids, issuer bids, going private transactions, and related party transactions.

Although it may appear that having multiple and overlapping instruments available to redress abuses by a controlling shareholder strengthens the protections available to minority shareholders, there are several infirmities within the current system that hobble its general effectiveness. First, there are simply too many different instruments in the minority shareholders' arsenal. This engenders overlap and confusion. Depending on whether a minority shareholder's action against a controlling shareholder is framed as an alleged breach of securities law, the corporate fiduciary duty, or the oppression remedy, quite different consequences ensue. This is due to the different substantive rights and remedies in each, the different modes of prosecution (public for securities law, private for corporate law), and the different forums for resolution (administrative review and possibly a hearing

for securities law, the courts for corporate law). Second, the multiplicity of instruments hobbles the creation of an extensive body of precedent under any single instrument. Consequently, it is difficult for both controlling and minority shareholders to know how the law will balance their respective interests in particular circumstances. Third, we are concerned that OSC Policy 9.1 has subverted the incentive (indeed, the capability) of shareholders and directors of Canadian corporations to negotiate directly the resolution of disputes over related-party transactions. The excessively detailed code of conduct elaborated in OSC Policy 9.1 insinuates OSC staff into the heart of disputes over self-dealing transactions, attenuating the need for those parties with the economic stakes to argue with controlling shareholders and management over related-party transactions (Daniels & Waitzer, 1994). The code has further undercut the incentive for board members to take the responsibility for crafting review processes for self-interested transactions tailored to specific circumstances. In this respect, in some circumstances the policy is far too stringent (in prescribing directorial review and disinterested shareholder voting, for example), whereas in others it is too lax (such as for significant transactions that are less than the 25 percent market capitalization tripwire for its non-disclosure obligations).

We regard the rationalization of the system of minority shareholder protection to be an urgent priority for the federal government, given the need to protect the integrity of the federal corporate law regime and to reduce costs for Canadian shareholders. At present, the substantive rights and remedies set out in OSC Policy 9.1 encroach on the corporate governance regime contemplated by the *Canada Business Corporation Act*. That is not to say, however, that the existing corporate law regime alone affords adequate protection to minority shareholders. There is a need for the federal government to review its own legislative scheme to determine which modifications are appropriate in light of the experience of the corporate and investor communities with both the oppression remedy and OSC Policy 9.1.

Policy Implication 9

- The federal government should commence a review of the various federal and provincial regulatory initiatives affecting minority shareholder rights to ensure that minority shareholders enjoy effective and rational protection against abuse by controlling shareholders.

As part of its review of the existing regime of minority shareholder protections, the federal government should also consider the desirability of expanding the disclosure and directorial voting provisions respecting interested material contracts or transactions to include those contracts or transactions involving the corporation and controlling shareholders. We suggest that class-action suits by minority shareholders against controlling shareholders be allowed when there is evidence of serious abuse.

We have argued (above) that mandating a certain number of outside directors on boards is unlikely to be effective unless three conditions are met. First, as suggested in Policy Implication 2, outside directors must be completely independent of the firm, i.e., they must have no commercial relationship whatsoever with the firm, nor with any other firm controlled by the firm's controlling shareholder. Second, outside directors must have strong incentives to protect public shareholders.

We believe this can be accomplished by giving outside directors performance-related compensation, and by rationalizing director liability, as proposed in our Policy Implications 3, 7 and 8. The third condition required for outside directors to be effective is that they must be empowered. We now turn to this.

There are sensible economic reasons for having insiders on boards of directors; they bring expertise and experience that outsiders seldom have. Nevertheless, external oversight and the vetting of self-interested transactions is a fundamental underpinning of effective corporate governance in a closely held economy such as Canada's. We believe that the board of directors of a closely held company is unlikely ever to be an effective forum for monitoring such transactions. The power and influence of the dominant shareholder are simply too pervasive. Therefore, we recommend that a new forum be established.

We suggest that a special committee of the board monitor and review the corporation's activities with controlling shareholders, other entities controlled by the controlling shareholders, and other insiders (non-shareholder officers and directors) to ensure fairness to minority shareholders. This would permit some institutional experience and memory to be accumulated with respect to non-arm's-length transactions and contracts.

Policy Implication 10

- The board of directors of any public Canadian company with a dominant shareholder should be required to establish a *conduct review committee* to approve significant non-arm's-length transactions and contracts. This committee should be composed entirely of outside directors (as defined in Policy Implication 2). Members of the conduct review committee and other members of the board should be liable to class-action lawsuits by minority shareholders when they deliberately, or negligently, allow improper non-arm's-length transactions or contracts to occur, but should be protected by a due diligence defense. To avoid frivolous suits, the courts should not hear cases unless there is evidence of grievous harm.

Conduct review committee approval could substitute for minority shareholder votes in many, perhaps most, cases. This would address a key criticism of Ontario's rule 9.1; that its requirements for shareholder consultation are too onerous and costly.

If the duties of controlling shareholders toward minority shareholders are to have any real content, minority shareholders must know when and how their interests might be threatened. Therefore we believe another critical issue is the timely disclosure of related party transactions.

Policy Implication 11

- Timely and full disclosure to all shareholders of all material contracts and transactions proposed between controlling shareholders, or the entities they control, and the corporation should be required.

Institutional Investors

A recurring theme in several of the studies in this volume has to do with the recent growth in power and importance of institutional investors. Rao and Lee-Sing (1995) show that institutional investors now control 38 percent of the dollar value of the Canadian firms in their study. While this is less than the comparable figure for the United States, 53 percent, it is nonetheless large — and it is increasing rapidly.

Public pension funds, such as the Ontario Teachers fund, and private pension fund managers, like Jarislowsky and Fraser, now control multibillion-dollar stock portfolios. By threatening to use their substantial equity blocks to back takeovers or proxy challenges by dissident shareholders, these large institutional investors can displace managers whom they believe are not serving the shareholders. In the United States, institutional investors have caused a revolution in corporate governance, much to the dismay of many top corporate managers. Foerster (1995) examines pension funds in Canada, and argues that the same is likely to happen here. Macintosh and Schwartz (1995) find a correlation between institutional ownership and corporate performance. This leads them to be relatively optimistic about the contribution institutional ownership can make to the Canadian system of corporate governance. However, Rao and Lee-Sing (1995) find no relationship between institutional ownership of Canadian firms and indicators of corporate strategy (like R&D spending and foreign market penetration), or general performance indicators (like return on assets or firm growth). In contrast, among U.S. firms they do find a link between high institutional ownership and good general performance. This is consistent with McConnell & Servaes (1990) who also document a relationship between institutional investors' stakes and high market-to-book ratios in U.S. firms. Many other studies argue for similar links.

However, as Patry and Poitevin (1995) explain, an increasing number of studies suggest institutional investors are overrated. A key issue in this connection is skepticism about pension fund managers learning enough about diverse business operations to make reliable business decisions. In the 1960s, conglomerates were touted as a way for a single team of superb managers to run numerous disparate businesses. The conglomerates of that era were largely failures. Post mortem examinations show problems in managing diverse divisions and subsidiaries to be the prime cause. Perhaps all the best conglomerate managers moved on to pension funds?

Expecting pension funds to be the holy grail of good corporate governance is unrealistic. However, even if pension fund managers take only measured and focused action to prod recalcitrant directors to do their jobs, substantial improvements in corporate governance might result. Some studies that are critical of pension funds and other investors seem to doubt that even this is likely, however. They point to serious governance problems within pension funds that may undermine their effectiveness.

Who are the people who run pension funds? How well do they do their jobs? What incentives do they face? To what extent do they promote their own interests, or interests other than those of their beneficiaries? These are critical questions that have largely gone unasked in Canada, despite the fact that pension fund managers regularly make multibillion-dollar decisions that constrain the decisions of large corporations and affect the retirement security of millions of people.

In public-sector funds, there is a nagging fear that those in control of pension funds might be there more for their political connections than for their financial expertise. Romano (1994) finds that public-sector pension funds earn statistically significantly lower returns than private sector funds, and attributes this to politically motivated “local initiative” investments.

In corporate pension funds, Lakonishok *et al.* (1991, 1992a, 1992b) present disturbing evidence that pension fund managers choose portfolio managers less for the performance of their investments than for their ability to generate good excuses when their portfolios do poorly. Lakonishok *et al.* document surprisingly poor portfolio returns on corporate pension funds. In general, most corporate pension funds would do better on a risk-adjusted basis simply to buy and hold broad market indices. Lakonishok *et al.* argue that conflicts of interest between plan beneficiaries, plan sponsors, and portfolio managers are largely responsible for this poor showing. Corporate treasurers in sponsoring firms may be more interested in expanding the influence of their office than in earning optimal returns. Also, portfolio managers may be more interested in pleasing the corporate treasurer (and thus getting their investment contracts renewed) than in producing optimal financial returns.

In Canada, the sheer size of institutional investors, particularly public pension funds, may itself be a double-edged sword. Fearing the public scrutiny that often accompanies vigorous action, even in circumstances where it is appropriate, public-fund managers may shun activism that is not in response to a discreet management-initiated transaction, like a poison pill plan or a change in corporate capital structure.

If pension funds themselves have serious governance problems, assigning them an important watchdog role over corporate governance may be akin to setting the fox to guard the henhouse. Before they can adequately play such a role, public- and private-sector pension fund managers’ incentives must be properly aligned. This suggests a need to clarify the underlying economic purpose of both public and private pension funds — which is to provide retirees with financial security. Pension fund portfolios should be managed to benefit the beneficiaries — not politicians, not political insiders, not corporate treasurers, and certainly not fund managers.

Ultimately, the most powerful way to ensure that pension funds are managed in the interests of their beneficiaries would be to introduce direct competition for beneficiaries’ pension dollars. This could be accomplished by allowing employees themselves to allocate their pension money among several portfolios, each with stated investment strategies and performance records. Pension fund management could even be completely divorced from corporate management. For example, employees of Bell Canada could choose to put their money in any certified pension fund, not just

those assigned contracts by Bell Canada. This would amount to moving toward defined contribution pension plans and away from classical defined benefit plans.

Defined contribution or money purchase plans are akin to Registered Retirement Savings Plans (RRSPs), but in this case either the employer alone or both the employer and employee make regular contributions. The beneficiary receives the accumulated amount of these contributions when she retires. Also, the employee can allocate her share of the asset pool as she chooses among several investment funds associated with the pension plan.

In defined benefit plans, the employer promises a specific level of benefits related to the retirees' years of service, top five years' wages, etc. Either the employer alone or both the employer and the employee make regular contributions. Theoretically, both the investment strategy and the responsibility for shortfalls rest with the employer only. In practice, when a defined benefit plan becomes seriously underfunded, the employees are usually asked for higher contributions or given lower defined benefits — or both — as occurred recently for public-sector employees in Alberta. Even when the contributions come solely from the employer, those contributions (and the benefits they pay for) are a part of labour contract negotiations and are subject to change. It is arguable that there is really no such thing as a “pure” defined benefit plan, in that in all pension plans employees potentially pay some costs for poor investment performance.

Hybrid plans, part defined benefit and part defined contribution, are also common. Most corporate plans are de facto defined contribution plans with defined benefit floors. Employers make “voluntary inflation adjustments” in the defined benefit when the fund's assets do well, but guarantee a basic floor level of payments, and sometimes even a basic partial inflation adjustment, when they do poorly. In such plans, the employees gain the benefits of good pension fund management and so should worry about the funds' investment strategies.

From a detached economic standpoint, defined contribution plans are preferable because the beneficiaries' property rights are clearly defined: they own the fund's assets. In defined benefit plans, although the employer is the *de jure* owner of the fund's assets, real property rights are vague. Since it is not clear who bears the costs of poor performance and who gains the benefits of good performance, no one has a clear incentive to press for good governance of these pension funds.

Given the advantage of defined contribution plans, why are most large pension plans defined benefit plans? First, the sponsors retain day-to-day control of the assets in defined benefit plans. Pension funds' investment strategies can be altered in the interests of the firm or government that sponsors them, often to the detriment of the beneficiaries. Second, defined benefit plans provide corporations with tax-free savings accounts. Bodie *et al.* (1985) show that U.S. companies with extra cash overfund their defined benefit pension plans so that in times of cash shortfalls they can adjust their contributions downward. This is accomplished by strategically altering the actuarial assumptions used to calculate the firm's contribution. Third, defined benefit plans are more forgiving of poor portfolio management because the ownership of the assets being managed is muddier. (Do they belong to the beneficiaries or to the employer?) Finally, defined benefit plans offer employees a false sense of security by promising a fixed annual dollar amount during their retirements. In fact, new

securities like Government of Canada inflation-indexed bonds, allow defined contribution schemes to offer even more security than defined benefit plans.

We believe none of these reasons justifies the current reliance on defined benefit plans, and that a shift to defined contribution plans would be in the broad public interest.

Policy Implication 12

- Corporate and public-sector pension plans should be shifted away from a defined benefit system toward a defined contribution system. This could be accomplished by requiring that all pension plans offer beneficiaries a *defined contribution option*. Beneficiaries should then be given as much choice as possible as to how their pension dollars are to be invested.

In defined contribution plans, the ownership of the pension assets is clear: *they are the sole property of the beneficiaries*. Pension fund managers should therefore be acting solely for and in the interests of the beneficiaries. Thus, we make the following recommendation.

Policy Implication 13

- The fiduciary duty of pension fund managers to the beneficiaries of pension funds should be clarified and strengthened. This fiduciary duty should be to maximize the value of the portfolio while exercising prudent risk management. Pension fund managers who deliberately or negligently fail to do this should be liable to *class-action lawsuits* by the beneficiaries. A reasonable effort to fulfill these duties should constitute a defense against such lawsuits.

To ensure further that senior pension fund managers represent beneficiaries, we would like to see more democracy within pension funds. Pension fund managers should not be appointed by corporate management or by politicians. If shareholders elect the directors charged with safeguarding their interests, should not pension plan beneficiaries have analogous power? If CEOs must disclose their compensation, ought not the same apply to pension fund managers?

Policy Implication 14

- The senior managers of corporate and public sector pension funds should be elected by the beneficiaries. In addition, the compensation of top pension fund managers should be disclosed to beneficiaries.

A system that allowed proxy challenges would also make it possible for outsiders to challenge the fund's management strategy. In short, we are proposing the *corporatization* of public and corporate pension funds. Pension funds should be run like firms and, as in firms, their top decision-makers should have responsibilities and liabilities similar to those of a board of directors.

If beneficiaries are to challenge the decisions of pension fund managers, information about the performance and composition of the funds' assets must be available to them.

Policy Implication 15

- Pension funds should disclose information as to the contents and performance of their portfolios to beneficiaries on a quarterly basis. The average length of time the fund has held each asset should also be disclosed. The individual components of market index portfolios need not be specified. These reports should be subject to uniform accounting standards and be audited regularly.

One cost of such a disclosure rule is that it might possibly deter innovative forms of fund management because of the risk that expensive investment strategies adopted by some fund managers would be appropriated by others – the public good problem. However, particularly in the time-sensitive environment of capital markets, we are skeptical that historical reporting of investments would unduly compromise innovating firms.

An important issue that arises here is so-called “window dressing” by fund managers. This occurs when fund managers sell their “dogs” to buy stocks that have done well just prior to reporting the contents of their portfolios. The result of window dressing is that funds sell low and buy high – not exactly a formula for financial success. Lakonishok *et al.* (1991, 1992*b*) report that this practice is common among pension funds in the United States, because having high performers in the portfolio shows that fund managers chose at least some good investments, even though others were less profitable. (Some suggest that window dressing also explains the positive correlation between institutional ownership and firm performance identified in some studies.) Apparently this increases the portfolio manager's chances of retaining the investment contract with the fund sponsor. To stop this practice, we propose that pension funds also disclose the length of time they have held the assets in their portfolios.

It is our hope that these reporting requirements will encourage more pension funds to hold more indexed portfolios. We agree with Patry and Poitevin's (1995) conclusion, supported by Weisbach, that pension funds ought to be indexed more than they are. However, we also consider this to be a symptom of deeper governance problems. We believe our suggestions in this section address the cause of this symptom, in that they would improve pension fund governance so that pension funds would move independently to index more of their portfolios. There are valid reasons for pursuing more complex investing strategies, and pension funds should have some flexibility in this regard. Preventing pension funds from following such strategies by requiring a certain level of indexing would, in our view, be a mistake.

Despite overblown claims and legitimate questions, pension funds and other institutional investors can probably become a strong force for better corporate governance in Canada. At present, however, the effect of institutional investors may be undermined by a number of legal impediments that limit their voice in corporate governance matters. For instance, there is concern that the shareholder proposal process, which is intended to make it easier and less costly for dissident

shareholders to communicate with all shareholders by allowing them to piggyback on management's information circulars, may be of limited value in disputes over corporate governance. This stems from the argument that such matters as information circulars are for the purpose of "promoting general economic, political, racial, religious, social or similar causes". The corporation can thus refuse to circulate a dissident proposal. There is also concern with the 200-word limitation on the size of the statement that can be made in support of a proposal. Finally, there is concern with the breadth of the definition of "solicitation" set out in the proxy rules of Canadian corporate legislation. The issue is that this definition could require large dissident shareholders who are talking with each other in contemplation of activism to file a dissident proxy circular, which is extremely costly.¹⁵

While the precise effect of these legislative restrictions on institutional voice is a matter of dispute, we believe that little would be lost by relaxing these rules, especially given our earlier recommendation calling for heightened disclosure of institutional ownership in Canada. As is clear from our earlier discussion, we regard informed, measured, and responsible institutional shareholder activism to be one of the linchpins of a modern system of corporate governance. We are also of the opinion that, given the right legal framework, Canadian institutional investors can play a constructive and responsible role in corporate governance. This accounts for our reluctance to codify rigid governance structures in corporate legislation that are inappropriate in a range of settings. By empowering large institutional shareholders to play a role in Canadian corporate governance, corporate and securities regulators will be free to play a more passive, enabling role. Such a regime is much more likely to result in optimal governance arrangements than one driven by governmental or quasi-governmental action. Therefore, we make the following recommendation.

Policy Implication 16

- The federal government, in association with the provincial securities commissions, should establish a joint task force to carry out a systematic review of corporate and securities legislation in order to remove any unnecessary impediments to institutional shareholder voice.

Key issues to consider in this review should be the status of institutional investors as insiders or controlling shareholders, and institutional investors' freedom to communicate with each other to address corporate governance problems. When institutional investors take large stakes in companies but do not become involved in detailed management decisions, there should be a way for them to avoid being designated as controlling shareholders, and still be free to communicate with each other about certain general corporate governance problems.¹⁶ One can envision cases where pension funds truly become controlling shareholders and might oppress minority investors. However, the circumstances under which a founding family is designated as a controlling shareholder and those under which a pension fund should be so designated should perhaps be different.

One important factor that lessens the positive effect of mutual and pension funds on corporate governance in this country is the rule(s) restricting foreign securities in their portfolios (Daniels & MacIntosh, 1991; MacIntosh, 1993; Daniels & Halpern, 1995). Although the use of derivatives

allows pension funds to reproduce the risk characteristics of foreign portfolios, the fact remains that they are restricted to the basic return they can earn in Canada.

The rule confining mutual and pension funds to Canadian investments has two effects on corporate governance. The positive effect is that, since mutual and pension funds have few other places to put their money, they cannot simply sell out when a firm has management problems. They have little choice but to intervene to try to improve the governance of their investments. The negative effect is that if the funds cannot improve the governance of firms whose stock they own, they are nevertheless stuck with it and have only a limited pool of other Canadian companies as possible alternative investments. If there are intractable governance problems in a preponderance of the companies, the funds may be forced to hold stocks they would otherwise shun. This allows poorly governed firms to raise capital by issuing securities on artificially favourable terms, which, in turn, enables corporations to make investment and operating decisions that are economically perverse. Indeed, we suspect that such mercantilist policies have had a devastating effect on the growth and development of the Canadian economy.

On balance, we believe the foreign investment restrictions on Canadian mutual and pension funds to be detrimental. The additional fact that these restrictions prevent mutual and pension funds from diversifying as much as they otherwise would (although derivatives help here), tips the verdict firmly on the side of free international capital flows.

Notwithstanding, there is yet another reason for allowing Canadian mutual and pension funds to diversify freely. It would not be economically healthy for Canadian finance to become completely dominated by pension funds. Might small shareholders need protection from oppression by large funds as much as from any other large shareholder? At present, we think the answer is “no because mutual and pension funds are generally not inside parties to the sorts of corporate decisions that raise concerns about oppressive non-arm’s-length transactions — such as asset transfers, securities issues, and the like. However, if the assets of mutual and pension funds continue to increase rapidly and their portfolio choices continue to be restricted to Canadian securities, there is a danger that the funds might come to so dominate Canadian finance that small investors might be slighted. In our opinion, this is another argument for allowing Canadian mutual and pension funds to diversify internationally without restrictions.

Policy Implication 17

- Canadian mutual and pension funds should be free to invest as much or as little in Canada as they see fit.

We recognize that adopting this policy will affect the finances of both governments and corporations. Governments can finance their deficits more easily when they can draw on captive investors. It should be recognized, however, that the current Canadian content rule constitutes a hidden tax on Canadians’ savings. If Canadian governments obtain funds on better terms because pension money is forced to remain here, this means Canadians’ retirement savings are earning less than they would if invested at globally competitive rates. Current thinking in public finance favours

consumption taxes, or taxes on the part of income people spend on consumption goods. Taxes on savings are seen to be bad because they discourage capital formation. Although public-sector governance is beyond the scope of this study, we speculate that Canadian governments might have been forced to begin their current fiscal house cleaning sooner if they had had to compete for capital in global markets, and that the present task would not have become as great as it is.

Complex Firms: Conglomerates and Multinationals with Public Shares

The main feature of these firms that raises concerns related to corporate governance is the ease with which money can be transferred between parts of the group of companies when each of the parts has a different set of shareholders. This is the same basic problem that causes concern in closely held firms in general, but here it can arise in many different ways. In our view, these problems are best addressed through the initiatives discussed earlier in respect of controlling shareholders. The most important initiatives in this context are that, if they have publicly traded shares, the subsidiaries of multinationals and firms in conglomerate groups should have conduct committees and should be required to disclose the details of non-arm's-length transactions.

Requirements that Canadian citizens serve on the boards of the Canadian subsidiaries of multinationals are unlikely to have any real effect. By choosing Canadian employees of the multinational, or Canadian employees of firms dependent on the multinational for business, the force of this rule can be largely dissipated. Rao and Lee-Sing (1995) find no strong correlation between the nationality of board members and firm performance. (Actually, they find weak and mixed evidence that more foreign directors might boost performance.) There appears to be no strong case for continuing this requirement unless it is strengthened to require completely unrelated Canadian directors. Even then, it is more important that the directors be unrelated than that they be Canadian.

If it is thought to be important for political reasons to require Canadian citizens in key positions in the Canadian subsidiaries of multinationals, our recommendation (Policy Implication 10) could be modified to require that the outside directors on conduct review committees be Canadian citizens. Economically, however, the citizenship of directors is unimportant. What is critical to the economic basis of Canadian corporate governance law is that directors be subject to lawsuits by Canadian shareholders.

Policy Implication 18

- Directors should be sueable.

Directors of Canadian companies resident in the United States and other developed countries are not judgement-proof. Canadians can sue in foreign courts. The important issue here is that shareholders should know what they are getting into. If a company moves to allow its directors to reside permanently outside Canada, this should require at least one-time shareholder approval and should be clearly disclosed in the prospectuses of all new securities.

We see no problem in the proposal, mentioned in the *Canada Business Corporations Act* Discussion Paper on Directors' and Other Corporate Residency Issues (August 1995), to allow shareholder meetings outside Canada. Again, the key issue is that shareholders know what they are getting into. One-time shareholder approval should be required and prospectuses for all new securities should disclose this practice. We also see no problem in the same discussion paper's suggestion that the *Canada Business Corporations Act* allow certain records to be kept outside of Canada as long as those records are readily available electronically.

However, there are some suggestions in the discussion paper that we consider inadvisable. One is that non-resident directors post a bond. We believe this to be unnecessary. If a security's prospectus states clearly that directors can reside abroad, the investors know what they are getting into. Another inadvisable proposal is that director residency requirements be replaced with a "community interest" clause requiring director attention to "stakeholders" rather than to shareholders. Since directors now have clear duties to ensure that the firm honours its contractual and other legal duties to all its stakeholders, a general discretionary duty (such as that to shareholders) would serve only corporate insiders. We argue at length in our introduction to this volume that *a duty to all stakeholders is too multidimensional and vague to be a serious constraint on the actions of directors*. Boards can always find some group whose interests are promoted by even the most foolhardy decision. Theoretical accountability to everyone boils down to real accountability to no one.

Whistleblowers

Even with the best audited financial statements and the most principled directors possible, it is still conceivable that corporate insiders might bilk shareholders directly or expose their firm(s) to lawsuits by violating environmental rules, etc. In such cases, protecting whistleblowers is in the interest of the public as well as the shareholders. The U. S. government pays a bounty to whistleblowers who expose fraud in government contracting. (This is why so many \$700 toilet seats and \$400 hammers come to light there.) There is an equally strong case in Canada for laws to protect whistleblowers from retribution in both the public and private sectors. However, retribution can take subtle and intangible forms, so such laws might be impossible to enforce. This supports the idea, developed by Daniels and Howse (1995), of offering a bounty to potential whistleblowers.

Policy Implication 19

- Protect whistleblowers from reprisals. Offer them bounties where public money is involved. Permit shareholders to vote to offer bounties in private firms.

Takeovers and Friendly Sales of Control

One of the distinctive features of Canadian corporate law (compared to that of the United States) is that friendly sales of control fall within the statutory takeover regime. For instance, the *Ontario Securities Act* precludes any party who wishes to purchase control from a controlling shareholder or group of shareholders at a premium in excess of 115 percent of a baseline market price from doing so, unless such an acquisition occurs pursuant to an offer made to all shareholders in accordance with the takeover regime. This means that the bid is subject to minimum bid periods and a pro rata take-up, among other things. The purpose of such a rule is to promote fairness for minority shareholders by ensuring that they have an equal opportunity to share the control premium with the controlling shareholder when there is a change in control. The equal opportunity rule is also thought to deter sales of control to opportunistic acquirers who want to loot the corporation by transferring corporate assets to themselves on unfair terms. Because the rule prevents a controlling shareholder from cashing out her position completely (at a high premium), the controlling shareholder is bound to take the plight of minority shareholders into account when parting with a part of a control block. Nevertheless, against these alleged benefits, the rule imposes significant costs. A controlling shareholder might not want to hold any equity after control is relinquished. If so, she is forced either to take a more modest control premium (i.e., to the 115 percent ceiling) or to encourage the acquirer to buy all of the outstanding shares. In tandem, both effects increase the cost of control transfers, thereby discouraging their frequency.

We believe that the problems generated by entrenchment of lacklustre controlling shareholders are both significant and severe. Therefore, we think that a more appropriate way to deal with the prospect of *ex post* looting by an acquiring shareholder is through the use of the various disclosure and review mechanisms identified above in our discussion of controlling shareholders. We believe that such selective, substantive review, reinforced by shareholder oversight, would provide effective and more nuanced constraints on self-dealing activities by acquiring shareholders. We are dubious however, of the claims to equal sharing of control premiums rooted in general ethical norms or in specific shareholder expectations. In robust, efficient capital markets, the price of a company's shares generally include a discount for minority status.¹⁷

Policy Implication 20

- The application of the takeover rules now included in provincial securities legislation and applicable to friendly sales of control should be revoked.

Disclosure

We do not believe it is economically defensible to use a specific threshold of ownership (like 20 percent) to trigger a required takeover bid for 100 percent of a firm's stock. The main effect of this would be to entrench managers further by increasing the costs of takeovers. We do, however, believe that the disclosure of large shareholders' stakes is reasonable. Minority shareholders should know who the large shareholders are, and the public should know which companies are subject to influence by which institutional investors.

In the United States, section 13d of the *Williams Act* requires that the stakes of all shareholders who own more than 5 percent of a publicly traded firm be disclosed. In Canada, disclosure is required only of stakes greater than 10 percent, which means that Canadian shareholders and managers often do not know the identity of the shareholders of the corporation. In the United States, investors reaching the 5 percent threshold must declare their intentions if they are launching a takeover. This makes sense because most U.S. firms are widely held and, compared to the Canadian case, shareholders with stakes greater than 5 percent are rare. Section 13d is often criticized because the mandatory early disclosure of a takeover in the works usually causes the share price to rise, making the pursuit of the takeover more expensive for the acquirer. Requirements in other countries that trigger automatic takeover bids for 100 percent of a company's stock when an investor's stake exceeds 20 percent create the same problem. In both cases, attempts to protect the interests of small shareholders actually harm them instead — by deterring takeovers.

A very large body of empirical work, alluded to throughout this volume, supports the claim that the possibility of a takeover stimulates good corporate governance. This means takeovers must be a credible threat to poor managers. The public interest is therefore served by allowing the secret accumulation of stock in preparation for a takeover.

There is, however, an offsetting public interest in the full disclosure of significant shareholdings. In the highly concentrated Canadian economy many large public pension funds are fast gaining staggering clout. Individual pension funds now own 10 percent or more of many firms' voting stock. Inevitably, as these institutions become more activist, the sheer size of their holdings will raise important and legitimate concerns regarding their concentrated economic and political power. In this respect, we believe that the harsh glare of public scrutiny is the best way to ensure that large shareholders, like the corporations in which they invest, operate in a constructive and responsible manner. Therefore, we propose the following.

Policy Implication 21

- The identities and stakes of all shareholders holding in excess of 5 percent of the voting shares of Canadian public companies should be disclosed.

We do not recommend that a 5 percent stake trigger a bid for control. Nor do we recommend that it mandate a declaration of intentions regarding a possible future takeover.

Banks and Corporate Governance

In Germany, Japan, and some other countries, banks own large blocks of stock and play an active role in the governance of non-financial companies. In those countries, it is common for directors to be appointed by banks and for banks to be intimately involved in the strategic and tactical decisions of the firms whose stock they own. Some argue that this bank oversight is a powerful stimulus to good corporate governance and that it might obviate the need for takeovers, pension fund activity, etc. However, Morck & Nakamura (1994) proffer a less rosy view of this system, arguing that it effectively entrenches a network of insiders and depresses share prices. Morck and Nakamura

(1995) trace the somewhat tainted historical development of bank-centred financial systems in Germany and Japan, and discuss some of the potentially serious problems of such systems.

Could more equity ownership by Canadian banks improve corporate governance in Canada? Amoako-Adu and Smith (1995) find no consistent pattern in Canadian data relating firm performance to a firm having directors affiliated with financial institutions. Morck and Nakamura (1995) find a negative relation between firm performance and the presence of directors affiliated with Canadian banks. Although this could reflect banks and other financial institutions taking a more active role in the governance of troubled firms, and thereby perhaps performing a useful service, we must conclude that there is no compelling evidence to support a broader role for banks or other financial institutions in Canadian corporate governance. It is probably more socially useful to explore other options for improving corporate governance.

Policy Implication 22

- The role of banks in corporate governance should not be expanded.

Public-Policy Objectives and Corporate Governance

The decisions of Canada's large corporations can either support or undermine the ability of governments to pursue their objectives. In the past, governments have used targeted taxes and subsidies to influence corporate decisions. This has caused enormous increases in the complexity of the tax code, leading many to conclude that it is hopelessly capricious. Recently, some have advocated using director liability as an alternative tool to achieve social policy objectives.

Nakamura, Cragg and Sayers (1995) argue that this is an inefficient approach to realizing such objectives. All the arguments for precise and well-defined liability raised in the section above on director liability are overwhelmingly relevant here. Exposing directors to liability for back wages, environmental damage, or failure to achieve social policy objectives is likely only to deter competent directors from accepting seats on a board. Directors must be able to control the things for which they are liable. We believe required disclosure of firms' contributions to public-policy objectives is a much more appropriate course. It is also likely to be more effective.

It is commonly alleged, for example, that North American shareholders have short time horizons and that this results in lower R&D spending than in Japan or other countries where managers are allegedly free to have long-term outlooks. Giammarino's (1995) study presents fairly conclusive evidence that R&D spending raises share values, not just in the long term, but immediately. Thus, we have a case where both public policy and shareholders appear to want more R&D spending. The absence of a requirement that Canadian firms disclose their R&D spending serves only to protect managers of firms that do little R&D from scrutiny by shareholders. We therefore suggest the following.

Policy Implication 23

- Firms should be required to disclose their research and development spending. Those that do no R&D should be required to say so.

We believe other social policy objectives might be approached the same way. For example, if worker retraining were a national priority, companies might be required to disclose their annual spending in this area. If the social policy objective is actually important to the public, consumers can choose to support companies with their business in response to their disclosures.

Governance in Nonprofit Enterprises

Hirshhorn (1995) raises the issue of accountability in not-for-profit firms. Increasing fiscal pressure on all levels of government makes efficient governance at not-for-profit institutions such as hospitals and universities critical. Governments are also increasingly willing to contract out certain public goods and services to the third or not-for-profit sector. Thus, we believe Canadian governments should undertake a comprehensive review of the legislative framework for nonprofits to determine the adequacy and effectiveness of the mechanisms of accountability to taxpayers, donors and beneficiaries. This legislation should be updated regularly in light of changing practices and demands.

Policy Implication 24

- Both the federal and the provincial governments should establish special advisory committees of professional advisors to and representatives of various not-for-profit organizations, as well as independent experts, to review and suggest changes to legislation concerning the governance of nonprofit institutions such as public service organizations, hospitals and universities.

Hirschhorn's (1995) suggestions of independent reviews and stringent reporting requirements for non profits should serve as a starting point for such a review. A central issue the review should address is to whom should the directors of a nonprofit organization be accountable. Should hospitals be run in the interests of patients (the customers), physicians (the skilled workers), or taxpayers (the providers of capital)? To whom should the directors of nonprofit organizations have fiduciary duties? A comprehensive examination of the governance of Canada's hospitals, universities, Crown Corporations, and other nonprofit organizations is long overdue. The motivation for such an endeavour should not be any allegation of wrongdoing or waste, but rather the simple –somewhat sobering –facts that these institutions are tremendously important and that governments are running out of money.

Arbitration

If the rights of shareholders and pension fund beneficiaries are to have any real content, they must be enforceable at reasonable cost and within a reasonable time frame. The various proposals we have advanced here are aimed at creating new legal rights and obligations and at clarifying and

sometimes modifying old ones. Canada's legal system is already cumbersome and clogged. We do not want new corporate governance rules merely to add to the logjam.

We are also skeptical that the current adversary legal system can provide fair, prompt and reasonable settlements to corporate governance disputes. Long and costly legal battles deter shareholders from challenging corporate insiders. Since managers can use shareholders' money to pay legal bills, they have greater staying power. The formal legal system tips the balance too far in favour of big players.

The United Kingdom has developed an interesting way of dealing with this problem. *The Cadbury Report*, a detailed investigation into British corporate governance, established arbitration, rather than the formal adversary legal system, as the way to resolve corporate governance disputes. We believe a system of compulsory arbitration would be sensible in Canada too.

Policy Implication 25

- Corporate governance disputes should be settled by arbitration. They should only enter the legal system if the arbitration process is not properly followed.

One approach is for government to legislate compulsory arbitration. A more *laissez faire* approach would be to allow firms to include clauses in their corporate charters binding them, their directors, and their managers, to the decisions of arbitration committees. Shareholders would then be informed via prospectuses, proxies and annual reports as to whether the firm has so bound itself. Shareholder pressure would probably quickly result in almost universal acceptance of arbitration.

The arbitration committees should follow the laws and regulations established by governments. In corporate governance disputes, some variant of the following process might be used: each side names one arbitrator, and the two arbitrators then name a third; arbitration committees could then hear and rule on corporate governance disputes quickly and cheaply. Analogous systems could be established to arbitrate disputes related to pension fund governance.

5. A PUBLIC-POLICY PHILOSOPHY ON CORPORATE GOVERNANCE

The accelerating integration of world financial markets is fast making distinctions between the corporate governance systems of different countries irrelevant. If Canadian companies fail to provide adequate corporate governance, Canadian investors will simply move their money abroad. Canadian companies will soon be forced to compete with rivals from all over the world. All else being equal, the company with the best governance will prevail. Therefore, the best way for the government to improve corporate governance in Canada is to open up the country to international competition quickly rather than slowly, and to prevent poorly governed firms from surviving on subsidies or other government favours.

Coercive corporate governance rules should not be used to promote general societal goals such as more R&D, increased worker training, or low unemployment. Ontario's rules making directors personally liable for back wages did not achieve the goal of reducing unemployment in the province. Their only effect was to encourage directors to resign when they feared the firm might be in trouble. But that is precisely the time when it is most important to have a well-functioning board.

R&D spending has been shown fairly conclusively to increase share values, not just in the long run, but immediately. The link between a well-trained work force and high share prices is less well documented, but common sense says it must surely exist. By first "getting the legal and economic environment right" and then allowing boards, CEOs, institutional investors, and other players in corporate governance to focus on boosting share prices, government will indirectly promote these broader goals. Therefore, most of our specific recommendations are different ways of saying "Do not". Do not interfere too much in firms' internal affairs. Do not legislate the structure of the board or its size. Do not favour any particular ownership structure; etc. If government sticks to free market policies, Canadian firms will find that better corporate governance is in the cards whether they like it or not.

A free-market economy depends on visibly fair legal and economic systems. For political and historical reasons, concentration of economic power is a concern in Canada. It is therefore reasonable to require full disclosure and outside oversight where there is any possibility of unprincipled behaviour by powerful insiders. It is for this reason that whistleblowers should be protected. It is also why we advise full disclosure of compensation paid to insiders, and why we strongly recommend that conduct committees review non-arm's-length transactions and that the details of such transactions be disclosed.

In the global economy, no country can afford to make its corporate governance laws too onerous without encouraging companies to find other, friendlier, jurisdictions in which to do business. Neither can a country afford to make its rules too lax or investors will simply find other places to put their money. Establishing a balance, while a bold challenge, imposes a comforting, practical constraint on law makers.

ENDNOTES

- 1 M. Porter, Canada At the Crossroads: *The Reality of a New Competitive Environment*, Ottawa: Business Council on National Issues/Supply and Services Canada, 1991, pp. 10-12.
- 2 T. Hatzichronoglou, "Indications of Industrial Competitiveness: Results and Limitations," in *Technology and National Competitiveness*, edited by J. Niosi, Montreal: McGill-Queen's University Press, 1991, p. 191 (citing OECD data).
- 3 Data from International Monetary Fund, reported in *The Economist*, World Economy Survey, September 19-25, 1992, p. 17.
- 4 Statistical Abstract of the United States, various years.
- 5 Statistical Abstract of the United States, various years
- 6 Michael Porter, *The Competitive Advantage of Nations*, New York: The Free Press, 1990, p. 681.
- 7 R. J. Daniels, "Can Contractarianism be Compassionate?: Stakeholders and Takeovers," *University of Toronto Law Journal*, 1994.
- 8 The issue of the objective function of the firm is thoroughly canvassed in a symposium issue of the University of Toronto Law Journal devoted to Stakeholders and Corporate Governance.
- 9 347883 *Alberta Ltd. v. Producers Pipelines Ltd.* (1991), 80 D.L.R. (4th) 359 (Sask. C.A.); *Remington Energy Ltd. v. Joss Energy Ltd.*, unreported, Alberta Court of Queen's Bench, per Fraser J., Dec. 17, 1993; Re *MDC Corporation and Regal Greetings & Gifts Inc.* (1994) 17 OSCB 4971; and Re *Lac Minerals Ltd. and Royal Oak Mines Inc.* (1994) 17 OSCB 4963.
- 10 Several examples can be cited. The tax incentives contained in the 1963 federal budget which lowered withholding taxes on dividends from 15 percent to 10 percent for companies beneficially owned by Canadians to the extent of at least 25 percent of their voting stock, and also where the parent company and its associates held no more than 75 percent of the voting shares and the stock of the subsidiary was listed on a Canadian exchange; the establishment of the Foreign Investment Review Agency in 1974 and its attention to Canadian share ownership as one of the criteria necessary for entry into Canada; and the incentives set out in the Trudeau government's National Energy Program for Canadian ownership.

- 11 Also, since we would link compensation to how well the firm's shares do relative to those of other similar firms, the directors are insulated from any overall market fluctuations due to alleged myopia.
- 12 Such an option is initially "in-the-money" if, at the time it is written, it permits the CEO to buy stock at a discount from the current market price.
- 13 Exceptions should be made if corporate waste can be demonstrated; that is, if corporate resources were paid out to corporate management without any corresponding benefit to the firm.
- 14 However, the debate surrounding poison pills not yet over. If managers use them to drive up offer prices in takeover bids, poison pills may actually benefit shareholders. A recent study by Comment & Schwert (1995) takes this view.
- 15 For a more thorough discussion, see MacIntosh (1993).
- 16 See also MacIntosh (1993).
- 17 See also Macintosh (1993*b*).

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